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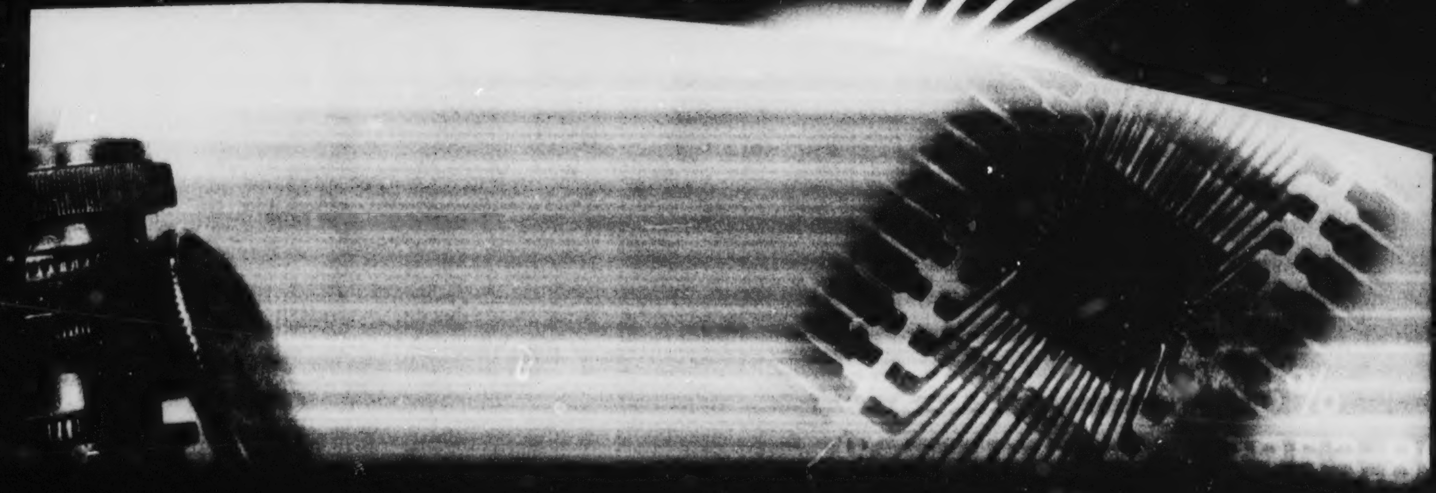
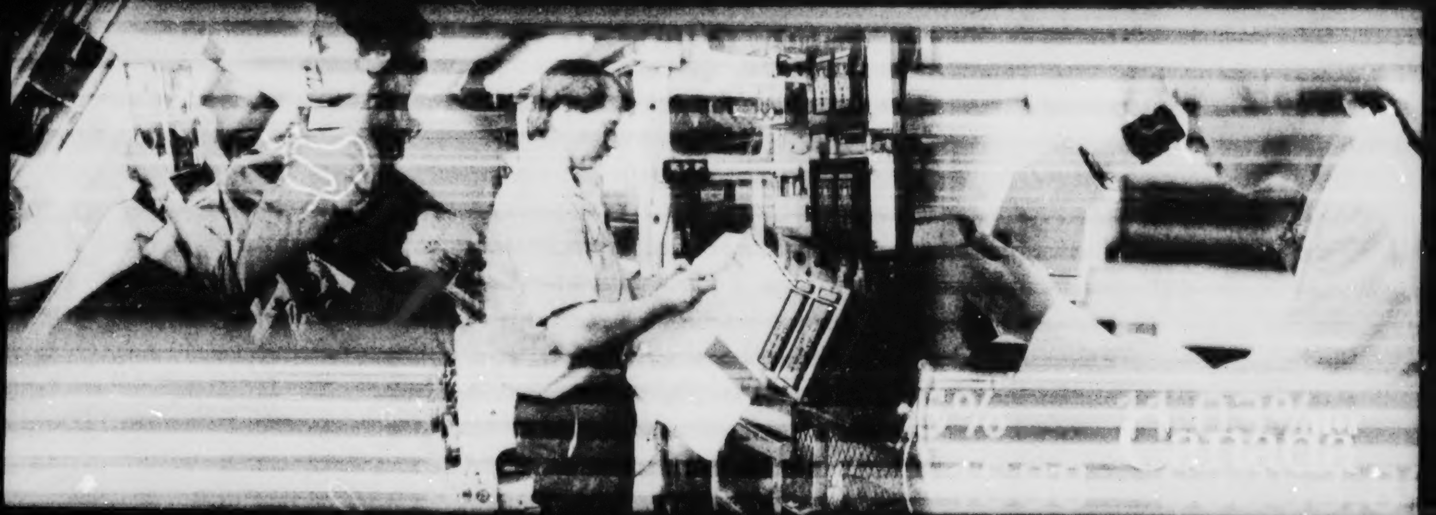


BECOME INVESTOR READY
BUILD INVESTOR RELATIONSHIPS

STEPS TO GROWTH CAPITAL



Canada

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Preface

The electronic version of the *Steps to Growth Capital* program is available through *Strategis*, Canada's Business Information Site (**http://growth.ic.gc.ca**). This program is designed specifically to help potential or established owner-managed companies access capital to fund the growth of their business. We strongly recommend that you take advantage of the *Steps to Growth Capital* program to enrich your understanding of the investment process and to improve your skills for accessing growth capital.

While there is no empirical evidence of a shortage of capital in Canada, there is ample evidence that small growth-oriented firms experience great difficulty accessing the necessary funds to grow their business. Many of these difficulties can be attributed to a poor understanding of the investment process.

The *Steps to Growth Capital* program concentrates on key elements of the investment process, defining common terms and providing a clear framework that owners of rapidly growing firms can use in their search for risk capital.

In the Overview, you will learn about the differences between conventional financing and risk capital. The Overview also outlines each of the steps involved in the search for the necessary capital to fund rapid and sustained growth of a business.

The remainder of the program details the investment process itself, a series of events that culminates in a firm securing the risk capital financing it needs to fund its growth. The process can be divided into two phases: becoming investor ready and building investor relationships.

Becoming investor ready involves an objective evaluation of your company, your management team and your growth potential. Based on your objective assessment, you will need to prepare an investment proposal to present the opportunity to potential investors and begin the process of building investor relationships. It is essential that you and your investment proposal speak to the needs of potential investors as you undertake to identify them, meet with them, negotiate with them and, eventually, close the deal.

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Module 2 : Demonstrate Your Investment Potential

Module 3 : Demonstrate Your Management Capabilities

Module 4 : Build an Investment Proposal

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Module 6 : Meet Potential Investors

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Introduction

While there is no shortage of funds available to small and medium-sized growth-oriented firms, evidence suggests that many of these companies continue to experience difficulty in securing funds to help their business grow. If you do not plan properly to raise funds from different types of lenders, you will most likely fail to raise the capital needed to launch your business and achieve your business goals.

To raise capital funds requires effective planning through eight logical steps. These essential steps, detailed in the individual modules of Steps to Growth Capital, must answer eight fundamental questions:

Step 1: What are your financial needs, i.e., how much money will you require to launch your investment opportunity?
Step 2: How will you demonstrate your investment opportunity's financial potential to attract investor attention?
Step 3: How will you show that your management team can successfully manage the investment opportunity — that it's a well-balanced team and can make the investment opportunity a real success?
Step 4: How should you write and structure your investment proposal to communicate your ideas as effectively as possible to investors?
Step 5: How will you identify potential investors for your idea or project?
Step 6: What strategy should you adopt when you approach investors to impress them with your investment opportunity?
Step 7: What steps should you take and what issues should you raise with your investors to ensure a successful final agreement?
Step 8: Finally, what must you do to close the deal, complete the due diligence process and, most important, ensure that a successful business relationship is consummated?

A major reason business owners fail in pursuing their project is a lack of planning. The best way to increase your chances of success is to follow these eight steps.

> "A business owner who fails to plan, plans to fail."
> (Joseph A. Covello)

Steps to Growth Capital has been prepared to help owners of growth-oriented firms think through their investment process in order to increase their chances of obtaining risk capital. It is aimed at potential or established, owner-managed companies that need different forms of financing to fund their growth.

You can go through Steps to Growth Capital in two ways. First, you may want to read the details of each module for a conceptual view of the steps and techniques involved in the investment process. Second, you may want to follow New Tech Distributors Corp. (a fictitious company introduced in the *Case Example* section at the end of this overview) through the installments that unfold at the end of each module to learn how to apply the concepts and techniques presented. We recommend using both approaches together.

> The capital to fund your business — it's out there.
> You need to understand the process involved in securing the financing you require.

Two key questions must be addressed before proceeding through Steps to Growth Capital:

1. What is risk capital and how does it differ from conventional financing?

2. Who are the most likely candidates for risk capital? Is your business a likely candidate? Will your business profile meet the interests and needs of potential venture capitalists?

The following sections address these questions. Then, in the ***What are the Steps in the Investment Process?*** section, you will be introduced to the Steps to Growth Capital modules with a brief description of each step required to secure risk capital, as well as some key questions you will have to explore along the way.

Risk Capital

What is Risk Capital?

Risk capital is another term for non-conventional financing. It refers to financing instruments that are not usually provided by conventional lending institutions such as chartered banks, mortgage lenders or insurance companies.

Providers of risk capital:

- assume more risk than providers of conventional financing because their investment in your business opportunity may not be backed by adequate security or collateral;
- risk losing their entire investment because they are prepared to exchange it for part ownership in your business; and
- earn a return based on the growth potential of your business.

Examples of risk capital instruments include:

- subordinated debts;
- preferred shares; and
- private equity (i.e., common shares).

In contrast, conventional lenders typically earn their returns in the form of interest charges and scheduled or flexible principal repayments.

Is there enough capital available to fund the needs of growing small and medium-sized businesses in Canada?

There is a more than adequate supply of risk capital in Canada. The Canadian Venture Capital Association estimates that, in 1997, $8.4 billion in venture capital was being managed in Canada. Approximately $2.4 billion was available for investment. And these figures do not include the capital available from informal investors or angels.

There is a lack of investment in small growth businesses because most of these companies are not considered "investor ready." In other words, entrepreneurs seeking risk capital have not prepared effectively. This may be due to incomplete analysis of financing needs, an inability to demonstrate investment potential or management capabilities, or an inability to generate interest among investors with a proposal.

Who Are the Most Likely Candidates for Risk Capital?

Preparing and presenting a proposal to a venture capitalist to secure risk capital is the key to securing funding. If your investment proposal meets the following criteria, risk capital investors will more likely consider you a good candidate for investment:

- your proposal demonstrates the potential for high, sustainable profitable growth;

- it is comprehensive and demonstrates that your project has the potential to exploit a market opportunity;
- it indicates that you have a qualified and balanced management team, and that all individuals associated with your business (founders/owners, board of directors, current investors, accountants, lawyers, consultants) have a good reputation and the ability to implement well-defined strategic objectives and plans;
- it clearly demonstrates the potential rate of return on the investment that is proportional to the level of assumed risk; and
- it confirms that investors have a viable exit strategy which offers a suitable return on their investment.

These requirements meet the four primary needs of risk capital investors:

- a strong management team capable of executing the strategic plan and managing growth;
- a rate of return that is sufficiently high to reward the level of assumed risk;
- a viable exit strategy to provide liquidity; and
- the ability to be actively involved in monitoring, influencing and controlling their investment.

It is particularly important to respond adequately to the needs and expectations of the various potential investors such as lenders (i.e., bankers for lines of credit or mortgage holders) and owners or shareholders (i.e., angels, strategic investors, venture capital firms, institutional investors or government-backed corporations for equity funding). Never lose sight of the fact that your investment proposal should focus on the needs and expectations of the investors you are trying to attract. Put the following questions on a sheet of paper in front of you as you write your investment proposal. Even though you may not be able to answer all the questions when you start, at least you will have a better understanding of what motivates investors.

- What is my investor looking for in this proposal?
- Have I been able to demonstrate clearly the potential benefits of my project?
- Does my investment proposal convey the message that our management team has the qualifications, maturity, common sense, business skills, experience and training to make crucial day-to-day decisions to exploit the growth opportunity successfully?
- Will my investor have access to a suitable exit strategy?
- What mechanism will there be for my investor to monitor, influence and control his or her investment?

Can I raise risk capital without the aid of advisors?

Yes. However, you may require the assistance of a lawyer, accountant, valuation expert or financial advisor. There are certain areas in which you may not possess the requisite skills. For example, there are legal issues in the investment proposal, identifying potential investors, negotiations and closing stages which require a strong knowledge of federal and provincial legislation and regulations. In addition, you may not have the skill in valuation or financial forecasting to complete these steps effectively. You should, however, be prepared to spend a considerable amount of time at each stage of the investment process.

Don't these advisors charge significant fees for their efforts? I don't want to spend the money I require before I have raised it.

As with any professional service, advisors will charge a fee for the services they provide. Fees depend on the role the advisor plays in the process. You may be able to manage many parts of the investment process by using your management team and other resources. Advisors may then act as "coaches" throughout the process, consulting on issues only when required. This allows you the benefit of their knowledge and the ability to control your costs for professional services.

What Are the Steps in the Investment Process?

The investment process is a combination of events and actions that facilitate access to risk capital financing. To access this financing, you have to:

- become investor ready; and
- build investor relationships.

Becoming investor ready involves an objective evaluation of your company, your management team and your growth potential. Based on your objective assessment of what you want to realize with your project and the market you want to compete in, you need to prepare an investment proposal for potential investors. As indicated before, the proposal has to show how the needs of potential investors will be met. Steps to Growth Capital includes four modules that will help you become investor ready:

- Identify Your Financial Needs;
- Demonstrate Your Investment Potential;
- Demonstrate Your Management Capabilities;
- Build an Investment Proposal.

Second, building investor relationships requires interaction between you and your prospective investor. Therefore, you need information that will give you a better understanding of what to expect as you go through the negotiating process and develop a long-term working relationship if the investor decides to invest in your business. Four modules will help you build investor relationships:

- Identify Potential Investors;
- Meet Potential Investors;
- Negotiate the Deal;
- Close the Deal.

Step 1: Identify Your Financial Needs

The first step in the investment process is to identify your financial needs. The Identify Your Financial Needs module discusses the range of financing requirements (i.e., capital assets, working capital, marketing costs) a growing business faces, the financing alternatives available (i.e., bank line of credit, supplier credit, mortgages, equity) and the implications of raising each type of financing. This module will help you answer the following questions:

- How much will you need? What are your financing requirements? When will you need the funds? How will you use the funds?
- How much of your financing requirements will have to be met by conventional financing? How much by risk capital financing?
- What are your alternative sources of financing? What are the different types of financing instruments? Which source of financing is associated with risk capital financing?
- What is the impact of each type of instrument on your company and the investor?

Step 2: Demonstrate Your Investment Potential

Regardless of the amount of risk capital financing you require, a risk capital investor must be convinced that your opportunity has significant growth potential. The Demonstrate Your Investment Potential module explains how to develop qualitative and quantitative information that makes clear your company's investment potential in terms of sales growth, profitability and return on investment. Ultimately, a reasonable pay back for the investor at exit (by way of an initial public offering, the sale of the company, the buyout of an investor third party or a buyback of the investor s share by your company) must be demonstrated when the investment proposal is presented. This module will help you answer the following questions:

- What type of information will demonstrate the merits of your investment opportunity?
- What are the investor's critical needs?
- What affects the exit value and how should you calculate the estimated exit value for the investor?
- Why is business valuation so critical for demonstrating the investment potential? What are the issues involved in determining the value of your company at the time of exit?
- What exit options will be available to the investor?

Step 3: Demonstrate Your Management Capabilities

Many prospective investors have no doubt that the presence of a first-rate management team is the single most important criterion in evaluating any funding opportunity. An investor must be convinced that you and your team are capable of exploiting the market opportunity and managing the growth of the business. The Demonstrate Your Management Capabilities module explains the importance of a balanced management team and the skills investors are looking for on your team. If you are not able to demonstrate your management capabilities effectively, the investor will probably not invest, even if your market opportunity and business concept are strong. Professional investors are like seasoned betters on horse races. Those who bet know that a skilled jockey (management team) can often bring a less-than-perfect horse (product or service) home a winner. This module will help you answer the following questions:

- Why is the competence of members of the management team critical? Which functional areas are most important to your potential investor?
- What evidence will show that your team members have complementary rather than similar managerial skills?
- How do you demonstrate that you and your management team have the critical management skills and attributes to manage all functions of your business?
- If there are weaknesses in the management team, how should you address them?

Step 4: Build an Investment Proposal

The investment proposal is the primary vehicle for communicating your investment opportunity to potential investors. A proposal must be the best that it can be: well written, easy to read, focussed on the key issues and appropriately packaged. The first shot is the most important. The Build an Investment Proposal module helps you integrate information about your financing needs, your investment potential and your management capabilities into a professional document. The investment proposal should be tailored to meet the needs of prospective investors. This module will help you answer the following questions:

- Why is the investment proposal such a critical part of the investment process?
- What are the essential components of a winning investment proposal?
- What information should you include in your investment proposal? How should you structure and present it?
- What key criteria do financiers use to evaluate investment proposals?
- What are the legal or regulatory issues associated with raising financing? Does the investment proposal have to be prepared in accordance with securities regulations?

Step 5: Identify Potential Investors

Once you have developed your investment proposal, it is time to create a list of potential investors who are most likely to be interested in, and compatible with, your needs and objectives. Business owners can spend many months writing and rewriting an investment proposal — time that could be wasted if the proposal doesn't make its way into the hands of the most appropriate financiers. The proposal must therefore be targeted toward the investors or lenders most likely to be interested in backing the venture. The Identify Potential Investors module provides an overview of the various sources of risk capital and investors' specific requirements. It will assist you in identifying the most appropriate sources of capital. This module will help you answer the following questions:

- How do you identify sources of funds? What resources are available to find potential investors?
- What criteria do investors use for considering investment opportunities?
- How do you rank the likelihood of potential investors investing in your company?
- What are some other important investor characteristics which will help you? How will these characteristics affect your financing?
- What are some additional legal or regulatory issues associated with identifying potential investors?

Step 6: Meet Potential Investors

The main purpose of the initial meeting with a prospective investor is to lay the groundwork for establishing what should be a long and prosperous relationship. When potential investors call for a meeting, it is the first indication to the owners-managers that their investment proposal is being considered. Now it's up to the entrepreneur to make the investment proposal come alive. Not only must business owners be able to present a convincing written case for funding, they must also be prepared to make a convincing oral case. The Meet Potential Investors module presents several methods of contacting potential investors. This module also outlines the steps in preparing for the initial meeting with a potential investor. This module will help you answer the following questions:

- What are the most effective ways to get your material to the potential investor? What are the advantages and disadvantages of each?
- What are the objectives of the first meeting with a potential investor? How can you make a strong first impression?
- What are the elements of an effective presentation?
- What happens if, after all this, the investor is favourably impressed? What should be expected after the first meeting?
- What additional legal or regulatory issues are related to meeting investors?

Step 7: Negotiate the Deal

Negotiating a deal with an investor is a critical step in the investment process. The central purpose of negotiating is to find a solution that will satisfy the needs of both parties. This step can be time consuming and sometimes frustrating for both you and your investor. The Negotiate the Deal module will assist you in preparing for negotiations with a serious investor and in knowing what to expect. It focusses on issues and techniques specific to the investment process. This module will help you answer the following questions:

- How do you prepare for negotiations with a potential investor? What issues will be negotiated?
- What key issues may affect the negotiations and the final agreement? What factors may influence the terms of your deal?
- What key legal issues could arise during negotiations and before reaching an agreement?
- What are some common pitfalls during negotiations? How can you avoid them?

Step 8: Close the Deal

Once you have negotiated an agreement, numerous pitfalls could still break the deal. The Close the Deal module outlines the necessary strategies and skills to close a deal. It describes issues that could make or break the negotiated agreement, and guides you through the due diligence process. It also provides pointers on how to manage your relationship with the investor after the investment has been made. This module will help you answer the following questions:

- What can go wrong between negotiations and a signed agreement? What are the key strategies and skills needed in order to close the deal?
- What is involved in final due diligence? How does it affect your final agreement?
- What key issues must you consider in managing a business relationship after the deal has been completed?

Case Example

The following case illustrates some of the key learning points contained in the Steps to Growth Capital modules. While the company in this illustration chooses one particular path in obtaining risk capital financing, it is by no means the only path that could be followed. Based on your experience, the needs of your business and the advice of others, you may want to follow a different route in your search for risk capital financing.

This case allows you to follow a fictitious company (New Tech Distributors Corp.) as it seeks risk capital to finance its growth. The case illustrates how the company addresses the key issues presented in each of the eight modules.

The Company

New Tech Distributors Corp. (New Tech) is a computer component distribution and assembly company located in Burnaby, British Columbia. The company distributes 30% of its products to companies in the United States and the balance across Canada. Stuart Chip, 38 years of age, started the company in his basement in 1993. He had just returned to Canada after spending five years with Digimoti, a Japanese semiconductor company. Today, New Tech has 20 employees and approximately $3 million in annual sales.

New Tech distributes computer components by courier, primarily to the replacement market, including small computer repair shops, as well as larger retail and service organizations. About 70% of its volume is transacted with small businesses while the balance is with larger "blue chip" companies. About 80% of the company's products are purchased from third-party suppliers and delivered to customers with no value added. The remaining 20% consists of computer power modules, which the company assembles.

Stuart currently owns 100% of the company but is considering offering some shares to his management team: Elizabeth Pratt, accountant; John Harley, sales manager; and Kevin Matley, who heads up production.

The company has experienced rapid growth, and research indicates its market continues to expand. Many 386/486 computers are showing signs of age; repairs are common and many users want to upgrade their existing computers. Home personal computers represent a growing market but, given New Tech's relatively small sales volume, the company believes it only accounts for 0.5% of the total North American market. Its marketing plan shows the company doubling sales in less than five years.

The Challenge

Despite Stuart's initial success, he is concerned that New Tech cannot continue to grow without an injection of additional capital. His bankers have advised him that he will not meet New Tech's sales objectives without such an infusion. Stuart wants to expand the power module side of the business by introducing a new line of products. At this point, he is considering non-conventional financing. But he has never done this before. Where does he start? How complicated is the process? How much money does he need?

Clearly, Stuart needs some answers. His banker recommends meeting with a financial advisor and gives him three names. Stuart interviews the three candidates and chooses one after checking references, including their past experiences raising financing for small businesses in his industry.

The Cash

Grant Argent, his financial advisor, asks Stuart about New Tech's financing needs. Stuart works with Elizabeth to determine the figures. He then asks Grant to list, on the whiteboard in his office, the various steps in raising financing. Grant lists the following:

- Identify New Tech's financial needs.
- Demonstrate New Tech's investment potential.
- Demonstrate New Tech's management capabilities.
- Prepare an investment proposal.
- Identify potential investors.
- Meet with potential investors.
- Negotiate the deal.
- Close the deal.

Module 1: Identify Your Financial Needs

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Executive Summary

This is the first of the four modules to help you become investor ready. It will assist you in analysing the important factors you need to consider in determining the *amount* and the *types* of financing necessary for successfully launching your investment opportunity.

To be commercially viable, companies must ensure that their future cash inflows exceed their future cash outflows. The difference in the timing between receiving and spending cash brings about the need to raise outside capital (or external financing). This module will help you to assess and calculate your financial requirements and to understanding the various options available to you in meeting your financing requirements.

- How much cash does your company need in order to fund the project?
- How much of the amount will be generated internally (by your own business) and from conventional lenders such as commercial banks?
- If you do not have enough cash generated internally and by conventional lenders, how much (if required) will you be able to raise from risk capital investors?
- What will you do with the funds?
- Of the financing options available, which ones are most suitable for you?
- What are the risks and rewards of each option?

A case example, New Tech Distributors Corp., is presented at the end of this module to help you through the step-by-step process of identifying your financial needs and financing requirements. If you have read the Steps to Growth Capital Overview, you are familiar with the company's background. This module continues with New Tech as the company identifies its financial needs and financing requirements.

This module covers six topics.

1. **Introduction**. Why is it important to calculate your financing requirements when seeking external financing?

2. **Establish your financial needs**. How much money do you need to launch your new product or service successfully? What about the timing and purpose for the funds? Do you want capital assets such as machinery or equipment, or more research and development (R&D)? Do you need more working capital such as accounts receivable and inventory? Will your new product line require large investments in advertising and special promotion?

3. **Analyse your financing options**. Once you establish your financial needs, the next step is to identify your financing requirements, that is, the source of funds for your capital assets or working capital requirements. How much money will be generated internally? How much will have to be raised externally? What will you require to finance temporary working capital, permanent working capital and capital assets? This section shows how to identify your requirements by preparing projected financial statements and a cash budget. It also looks at financing options, that is, which investors will provide the funds to finance your investment needs. It explains the difference between conventional financing and risk capital financing and why this is important. This section also explains the various types (short term and long term) of risk capital financing.

4. **Capital structure and mix**. This section looks at how you should go about determining the most suitable instrument (short term versus long term, conventional financing versus risk capital) and the most appropriate capital structure for your company (debt versus equity).

5. **The entrepreneur's needs**. This section will help you select the most suitable financing instruments and capital structure as well as integrate your business and personal perspectives with your funding needs and options. What implications do the various financing instruments have for your company?

6. **The investor's needs**. What constraints (if any) will your investor's interests and investment criteria impose on you and your company?

This module also includes a brief conclusion.

Details

1. Introduction

When growth-oriented businesses expand their operations, they usually require additional funds to finance their growth. They need to invest in assets to support their sales growth. Therefore, growth firms may need additional investments in:

- current or working capital assets (i.e. inventories, accounts receivable); and
- capital assets (i.e. equipment, machinery).

Throughout this module, we will refer to the case example, New Tech Distributors Corp., to show how *financial needs* and *financing requirements* (sources) can be calculated and identified. Background information and the challenges that New Tech faces were presented in the introductory Steps to Growth Capital Overview. More detailed information about the company's projected financial statements and financial performance is explained throughout this module and presented in exhibits 1.1 to 11.1.

Since there is considerable detailed information presented in this module about New Tech's financial needs and financing requirements, it is summarized in the case example at the end of the module. This should help you better understand the relationship between financial needs, financing requirements and how they are presented in financial statements for analysis and decision making. These statements are important to justify financial needs to potential investors.

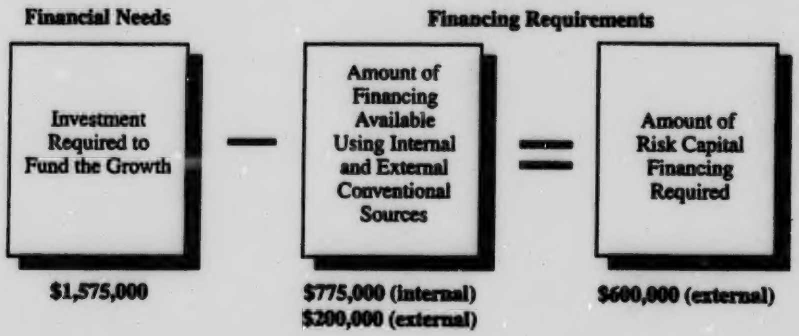
A Forewarning

Sections 2 and 3 of this module are somewhat technical in nature. Unless you are well versed with financial concepts and techniques, you should be prepared to spend some time reviewing the text to ensure you clearly understand the material.

You'll need a good understanding of these sections so you can explain and clarify your financial information and the assumptions used in your financial projections to potential investors. While you may have a financial advisor prepare your financial statements, you should still have a crisp understanding of all aspects of your investment proposal, including financial statements. This is important if you are to negotiate the terms of your investment proposal in a knowledgeable and credible manner. Remember, reading and understanding your own financial statements is the first step to becoming investor ready.

Figure 1.1 summarizes New Tech's financial needs and financing requirements. The left side of the figure shows that the company will need $1,575,000 to launch its new product line. The company's financing requirements will be obtained from two sources: internal sources (i.e. cash flow from operations and better use of its working capital accounts such as inventories and receivables) and external sources. External funds can be obtained from conventional lenders (i.e. a line of credit or term loan from a bank) or from risk capital (i.e. angels, venture capital firms). The right side of the figure shows New Tech's financing requirements, in this case $600,000 from external risk capital investors.

Figure 1.1
New Tech's Financial Needs and Financing Requirements


Financial Needs
Financing Requirements
Investment Required to Fund the Growth
Amount of Financing Available Using Internal and External Conventional Sources
Amount of Risk Capital Financing Required
$1,575,000
$775,000 (internal)
$200,000 (external)
$600,000 (external)

Let's examine New Tech's financial situation, including the analytical information required to justify the company's needs and requirements.

Income Statements
Exhibit 1.1 presents New Tech's financial performance through its income statements for three fiscal periods. It shows the company's actual performance for 1998 and projected 1999 and 2000 results. As shown, the company realized $3 million in sales revenue in 1998 and will be launching a new product line in 1999 that will require funding for working capital and the acquisition of capital assets. In 1999, the new product line will generate a $900,000 increase in sales revenue, or 30% over 1998. However, there is little change in income after taxes ($204,000 in 1998 versus $205,000 in 1999), which reflects the company's extensive additional expenses, particularly marketing costs (see advertising and special promotional program expenditure lines), research and development, and other related expenses to produce, launch and sell the new product line.

Statements of Retained Earnings
Exhibit 1.2 presents New Tech's statements of retained earnings showing the amount of retained earnings accumulated since the company began operations and the payment of dividends to its shareholders on an annual basis. As shown, the company accumulated $500,000 at the beginning of 1998, with $204,000 in earnings (income after taxes) added by the end of the year. In that same year, a payment of $50,000 in dividends was made to the shareholders. By the end of 1999, the company will have accumulated $839,000 in retained earnings, which is expected to increase to $1,277,000 by the end of 2000. Retained earnings are important for businesses since this money (internal sources of funds) is used to fund growth (working capital) and acquire capital assets (equipment, machinery, etc.). Note that the retained earnings (end of year) amount shown on this statement is brought forward to the balance sheet (Exhibit 1.3) under the heading Owners' equity.

Balance Sheets
Exhibit 1.3 shows New Tech's financial structure, that is, its balance sheets. A balance sheet shows what a company owns (assets) and what it owes its lenders (liabilities) and shareholders (owners" equity). In

1999, New Tech's total assets will increase by $1,049,000 for a substantial 43.7% growth. This reflects the additional financial needs to launch the new product line. As shown, total current assets (accounts receivable, inventories, etc.) will increase by $274,000, or 24.1%, while gross capital assets will show a $1,100,000 increment, or 62%. This reflects the acquisition of new capital assets to produce the new line of products. The lower portion of the balance sheet shows the sources of the funds. Total current liabilities (accounts payable, term loan, etc.) will increase by only $64,000, or 7.8%. These short-term sources will be used to finance the current asset accounts (i.e. receivables and inventory). The long-term portion of the liabilities will show a $200,000 increase, or 50%, while shareholders will invest an additional $600,000 for an increase of 132%. Retained earnings (income earned for the year) will increase by $185,000, or 28%. As shown, the largest increase from external financing will come from shareholders and reflects the amount that will have to be invested in the business by the existing owners and risk capital investors. At the outset, this suggests that this opportunity is too risky for conventional lenders to invest substantial amounts in the new product line; equity funds will have to be injected into New Tech to launch the new product line.

In the next three sections, three broad topics will be explored.

- The Establish Your Financial Needs section shows how to determine the amount of financing required to fund your growth.
- The Analyse Your Financing Options section focusses on the conventional and risk capital sources of financing that might be appropriate to meet your specific needs.
- The Capital Structure and Mix section describes what you should consider when determining the amount of conventional versus risk capital financing to fund your growth.

2. Establish Your Financial Needs

As shown below, to launch the new product line, New Tech will need $1,575,000 to be obtained from internal sources ($775,000), external conventional debt financing ($200,000) and external risk capital investors ($600,000). This illustrates the link between financial needs and financing requirements.

Financial Needs		**Financing Requirements**				
Investment Required		Internal Sources		External Sources		
				Conventional Debt Financing		Risk Capital
$ 1,575,000	=	$ 775,000	+	$ 200,000	+	$ 600,000

Let's begin by examining the composition of New Tech's $1,575,000 financial needs:

1. Working capital requirements	$ 200,000
2. Capital assets	1,100,000
3. Marketing costs	225,000
4. Cushion	50,000
Total	**$ 1,575,000**

Cash Flow Forecasts (Sources and Uses of Funds)

The $1,575,000 will be financed by internal sources (operating activities) and external sources (financing activities). Exhibit 1.4 presents an overview of New Tech's sources (where the funds will come from) and uses (what the funds will be used for). The business itself (internal sources) and the investors (financing activities) will provide $330,000 and $780,000 respectively to finance the purchase of the $1,100,000 capital assets.

Operating activities (internal sources)	$	330,000	(source)
Financing activities (external sources)		780,000	(source)
Investing activities (investments in capital assets)		1,100,000	(use)
Change in the company's cash account		10,000	(use)
Net change	**$**	**000**	

Statements of Changes in Financial Position

A detailed list of New Tech's sources and uses of funds is presented in its statements of changes in financial position (Exhibit 1.5). As shown, all the sources and uses of funds are grouped under three headings:

- Operating activities (internal sources)
- Financing activities (external sources of financing)
- Investing activities (where the funds will be spent).

Let's now examine in detail how New Tech's financial needs are calculated. We'll begin with the working capital requirements.

Working capital requirements ($200,000)

The first financial need deals with working capital accounts, and its make-up can be explained by the following equation:

Change in Working Capital = (Increase in Accounts Receivable + Inventory) – Increase in Accounts Payable

Working capital is made up of current assets and current liabilities. Working capital is the capital that allows you to fund the operations of your business on a day-to-day basis. *Current assets* are either cash or those near-cash accounts that can be converted into cash within the current fiscal year. They include marketable securities, accounts receivable and inventories. *Current liabilities* are financial obligations that will have to be paid within the current operating year. They include accounts payable, term loans, working capital loans and accrued expenses. These funds help to finance the current asset accounts.

In the case of New Tech., the relationship between accounts receivable, inventory, marketable securities, etc. (current assets), and accounts payable, term loan, etc. (current liabilities), gives a net increase or use of funds of $200,000. Basically, this is the difference between the current asset accounts (excluding the cash account) and the current liability accounts listed on the balance sheets (Exhibit 1.3) for 1998 and 1999. This difference represents the company's financial needs in net working capital. These figures are also listed on New Tech's statement of changes in financial position (Exhibit 1.5). The following summarizes these uses and sources of funds.

Accounts receivable	$ 100,000 (use of funds)
Inventory	75,000 (use of funds)
Subtotal	**$ 175,000**
Less: Accounts payable	50,000 (source of funds)
Net working capital	**$ 125,000**
Other working capital accounts	75,000 (use of funds)
Net change in working capital	**$ 200,000 (use of funds)**

Current asset and current liability accounts must be examined to determine how much is needed to invest in working capital. First, there is the cash-to-cash cycle, that is, the flow of funds that circulates in a business. For example, New Tech orders raw materials. After receiving these materials, it borrows from its bank to finance its inventories and pay its suppliers. It begins manufacturing and builds up a substantial finished goods inventory, which it ships to customers. New Tech then bills its customers, receives cash from customers, repays its loan and deposits the remainder in the bank. In the language of finance, this process is referred to as the cash conversion cycle.

The second element to consider is the distinction between the temporary (variable or fluctuating) and permanent components of working capital. Temporary working capital items usually fluctuate from zero to very high levels. For example, just a month before school starts, inventories are high. During July and August, external working capital financing is needed to finance the production of the inventory, to carry it in the warehouse and to provide credit to the colleges and universities. As the company receives cash from their sales during September and October, it liquidates or reduces the short-term financing it obtained from suppliers and bankers. Temporary working capital is considered a short-term need, and the monthly cash budget (which will be explained later in this module) helps to determine the funds required to finance this particular working capital requirement.

A normal level of receivables and inventories during the year is referred to as the permanent components of working capital. It is important to make the distinction between these two types of working capital requirements for financing reasons. Temporary working capital is financed by short-term loans and seasonal increases in accounts payable; permanent working capital or current assets can be financed by permanent liabilities (i.e. normal level of accounts payable as well as the current portion of long-term debt and even long-term debts and owners' equity).

How to calculate your working capital financial needs

The following methods for calculating your working capital financial needs focus on how long it takes customers to pay their bills (accounts receivable), the number of times (during the year) it takes for your company to turn the inventory around and how fast it pays your suppliers (accounts payable). As mentioned earlier, the increase in net working capital is equal to the increase in accounts receivable and inventory, less the increase in accounts payable.

To zero in on New Tech's working capital financial needs, management must first formulate its 1999 financial objectives for each item listed on its income statements (Exhibit 1.1) and balance sheets (Exhibit 1.3). Some of the financial objectives shown in New Tech's financial ratios (Exhibit 1.6) will be used to identify the company's financial needs for 1999 and, most important, should be incorporated in its investment proposal.

Potential investors (lenders and shareholders) are keenly interested in a company's financial objectives. These ratios help to answer many important questions:

- Is there enough cash in the business to pay suppliers and meet payroll?
- Will the business be able to service its debt?
- Will managers be able to manage business assets efficiently (working capital and capital assets)?
- Will the business generate enough return on its assets? On equity? On invested capital?
- Is the business financially sound?
- Will it maintain or improve its financial health?
- Will managers be able to manage its growth?

When financial objectives have been identified, the next points to cover are the assumptions or premises used to develop the operational plans required to achieve the financial targets. An investment proposal without financial ratios (or targets) is much like a medical doctor without medical tests who wants to decide about the needs of a patient.

As shown in Exhibit 1.6, financial ratios can be grouped under four categories: liquidity, leverage, management and profitability. Each category raises questions you will have to focus on as you prepare your financial objectives and respond to the questions, concerns and issues of your investors.

Liquidity ratios. Does the company have sufficient cash and near cash to pay its bills and payroll on time? Basically, liquidity ratios indicate the company's ability to discharge its current obligations in times of stress.

Leverage ratios. What is the proportion of a company's debt versus equity? These ratios display the methods and sources of financing used in acquiring assets and their impact on the earnings available to shareholders.

Management ratios. How efficiently is the management team using the company's assets to generate sales and profits? These ratios are useful in tracking the performance of managers in charge of specific operating functions such as production, marketing, inventories, accounts receivable or cash.

Profitability ratios. Is the business generating a sufficient return on its investments? These ratios show the relationship between profit and revenue generated, resources employed (assets) and shareholders' equity.

Let us now explore how financial ratios can be used to determine the funds needed to finance working capital requirements (i.e. accounts receivable, inventory and accounts payable).

Accounts receivable ($100,000)

As shown in Exhibit 1.5, in 1999, New Tech will need an additional $100,000 in accounts receivable. Accounts receivable represent money owed to a business by regular business customers for the purchase of products or services, which will be collected within a reasonable time (usually 30 to 90 days). They can also be described as the money owed to a company as a result of sales made on credit for which payment has not yet been received. As shown in Exhibit 1.3, New Tech's accounts receivable increase from $450,000 to $550,000. This $100,000 increment reflects a 30% increase in sales revenue (Exhibit 1.1), which is partly offset by an improvement in the way accounts receivable are managed. Exhibit 1.6 shows that the average collection period is projected to improve from 54.75 days in 1998 to 51.47 days in 1999.

Here is how the average collection period is calculated. It is a two-step process.

Step 1: Calculate the average daily sales

	1998		1999	
Sales	$3,000,000		$3,900,000	
Average daily sales	365	= $8,219	365	= $10,685

Step 2: Calculate the average collection period

	1998		1999	
Accounts receivable	$450,000	= 54.75 days	$550,000	= 51.47 days
Average daily sales	$8,219		$10,685	

Inventory ($75,000)

Also shown in Exhibit 1.5, in 1999, New Tech will need an additional $75,000 in inventory. The inventory account describes the monetary value a company places on the material it has purchased or goods it has manufactured. It usually represents the largest current assets of most manufacturing companies, and yet money invested in inventory does not earn a return. In fact, it costs money to maintain inventories. They must be stored, moved about, insured and protected from theft and deterioration. Inventory serves two main purposes. It acts as a safety mechanism to compensate for uncertainties in the timing and volume of supply and demand, and as a buffer between supply and demand that takes place at different rates.

Usually, a manufacturer like New Tech has three types of inventories: raw materials (the goods purchased from various suppliers, to be used for manufacturing purposes), finished goods (the products ready for sale) and the work-in-progress (the goods or materials tied up in various stages of the production process, somewhere between raw materials and finished goods). Since inventory is not a source of income, management makes an effort to keep it at low levels or to move it as fast as possible. This is measured by the inventory turnover ratio.

As shown in Exhibit 1.3, New Tech projects an inventory increase from $350,000 to $425,000. This $75,000 increment is due to a 30% increase in sales revenue (Exhibit 1.1) offset by a small improvement in the management of inventory (from 3.39 times in 1998 to 3.45 times in 1999). See Exhibit 1.6.

Here is how inventory turnover is calculated.

	1998		1999	
Cost of goods sold	$1,185,000	= 3.39 times	$1,465,000	= 3.45 times
Inventory	$350,000		$425,000	
Accounts payable ($50,000)				

Also shown in Exhibit 1.5, in 1999, New Tech will get the help of suppliers to finance its working capital needs by an additional $50,000. Accounts payable represent the most current debts of any business. This money is owed to suppliers of goods or services purchased on credit. Some of the increased needs to finance accounts receivable and inventories are provided spontaneously by creditors who are likely to permit a company to increase its levels of accounts payable as business activity expands.

There is no question that you can finance your accounts receivable and inventories from the credit you obtain from your suppliers. As shown on Exhibit 1.3, New Tech's accounts payable are projected to increase from $550,000 to $600,000. This $50,000 increment is due to a 24% increase in cost of goods sold (Exhibit 1.1). New Tech's average payable period decreases from 30 days in 1998 to 28 days in 1999. The company's strategy is to continue paying its bills as they become due in order to maintain a good credit standing with its suppliers. A company that is paying its bills faster may be taking advantage of trade discounts (this will be discussed later in this module).

Here is the way that the average payment period is calculated. The following information is drawn from Exhibit 1.1. This is also a two-step process.

Step 1: Calculate the average daily purchases

	1998		1999	
Purchases	$610,000		$710,000	
Freight in	$ 60,000		$ 70,000	
Total	**$670,000**	**= $1,835**	**$780,000**	**= $2,137**
Average daily sales	**365**		**365**	

Step 2: Calculate the average collection period

	1998		1999	
Accounts receivable	**$550,000**	**= 30 days**	**$600,000**	**= 28 days**
Average daily sales	**$1,835**		**$2,137**	

To summarize, New Tech's 1999 financial needs for working capital are as follows:

Accounts receivable	$ 100,000
Inventory	75,000
Subtotal	**$ 175,000**
Less: Accounts payable	50,000
Net increase in working capital requirements	**$ 125,000**

Other working capital accounts ($75,000)

Exhibit 1.5 also shows that in 1999, New Tech will need an additional $75,000 to finance other working capital accounts (current assets and current liabilities). As shown, these accounts are made up of the following:

Marketable securities	$	10,000	(use)
Prepaid expenses		10,000	(use)
Other assets		33,000	(use)
Supplies, etc.		36,000	(use)
Term loan		15,000	(source)
Working capital loan		9,000	(source)
Accruals		10,000	(use)
Net change in other working capital accounts	**$**	**75,000**	**(use)**

Capital asset requirements ($1,100,000)

Companies must also identify, in their investment proposal, a list of capital assets (also known as fixed assets), such as land, buildings, machinery and equipment required for the project. Such a list should be based on supplier quotations, which help to pinpoint exactly what is needed. Identifying capital assets precisely is important:

- to help maintain control over depreciable assets;
- for insurance purposes;
- to insure against letting the company's reserve for replacement of machinery and equipment become too low (or to be used as a slush fund); and
- to assist in the creation of a cost budget.

As shown in Exhibit 1.5, New Tech's gross capital asset requirements will be $1,100,000. The balance sheets for 1998 and 1999 show that these assets will increase from $1,775,000 to $2,875,000 ($1,100,000 increment).

Capital assets include the machinery and equipment used to manufacture a product, provide a service or sell, store and deliver goods. These assets are not sold during the normal course of business but, rather, are equipment or machinery used during the normal course of production. Examples include office furniture and business machines (i.e. desks, computers, adding machines, store fixtures, display cases, permanent fixtures, machinery used to make products, and delivery vehicles). These assets are expected to wear out over several years, that is, they are depreciable. Therefore, the amount of depreciation – the writing off of capital assets over a period of years – expressed as depreciation expense appears on the income statements (Exhibit 1.1).

The list of equipment to be purchased should be presented in the following way.

Capital Assets	**Model**	**List Price of Assets**
Addition to buildings		$ 550,000
Architectural costs		35,000
Engineering costs		60,000
Equipment		
Item 1	SS8-77T	65,000
Item 2	S33-8SS	87,000
Etc.		27,000
Machinery		
Item 1	666-S44S	75,000
Item 2	T-44-SS	81,000
Etc.		120,000
Total		**$ 1,100,000**

Marketing costs ($225,000)

The $225,000 amount for marketing costs represents the funding required to launch New Tech's new product line. It is included in two 1999 accounts, namely, advertising and special promotional program (Exhibit 1.1). These expenses will be paid by ongoing business activities, that is, internal sources.

Cushion ($50,000)

Although New Tech's managers are careful in estimating their financial needs for working capital, capital assets and marketing costs, these estimates are not 100% accurate. Anything can happen! The information contained in the projected income statements (Exhibit 1.1) and balance sheets (Exhibit 1.3) for 1999 is based on management's judgment and planning premises or assumptions. There are chances that some of these estimates will be higher and others lower. For this reason, managers usually take precaution when negotiating loans by providing other estimates based on possible changes in business circumstances (environment or industry). These assumptions pinpoint the additional funds a business will need if such changes are realized.

For this reason, management will go through a sensitivity analysis in which changes are made to several elements in the base case (e.g. sales revenue, cost of goods sold, salaries or acquisition of capital assets) to gauge the extent to which each element affects financial needs. Management will also determine the level of sensitivity each element has on the financial statements and examine, for example, the best (optimistic) and worst (pessimistic) financial scenarios to identify a level of "financial cushion" that may be required if the base case estimates are not realized. In short, management simply wants to reduce, as much as possible, the element of surprise and inform potential investors about "possible" increments in financing requirements. This $50,000 will be financed by internally generated funds and has already been included in various 1999 income statement expense items.

This topic will be discussed in more detail later in this module under the heading Sensitivity Analysis in this section.

The Forecasting Process

Once you have identified the investments required to fund your growth or financial needs ($1,575,000 in the case of New Tech), you should begin to pinpoint your financing options. Where will the $1,575,000 come from? Who will provide these funds? How much will come from internal sources, that is, your own operations? How much will come from external sources, that is investors (either from banks or from risk capital investors)? These questions will be answered in the next section of this module, Analyse Your Financing Options. But before you actually begin identifying your financing options, a little preparatory work is required: you need projections of your financial statements that incorporate both your financial needs and your financing requirements. Usually, projected financial statements are prepared for a period ranging between one and five years (annual projections), with a detailed monthly cash budget for the first year. Pertinent financial forecasts, in terms of details and number of years, depend largely on the nature of your business and your investors' requirements.

As a prerequisite to forecasting, your management team should have a clear vision of the business it wants to be in. Prepare a written mission statement, corporate priorities, and strategic and operational objectives, including specific plans (strategic and operational). These are essential to give your company a clear direction for the future with regards to operating environment, products, services markets, competitors and how the company expects to reach these goals. These objectives and plans are vital for preparing your projected short- and long-term financial statements and, more important, to confirm how the financial results will be achieved. For example, if your objectives and plans are to expand into new markets, this will ultimately have an impact on your projected sales revenue and cost of goods sold, levels of inventories and accounts receivable, and even your capital asset requirements.

Be thorough. Otherwise you may find yourself negotiating from a position of weakness. This could prove to be very costly.

The following gives essential steps in formulating reliable financial forecasts.

- Review past operating results to determine:
  - sales growth rates by product;
  - cost relationships to distinguish among fixed variable costs;
  - items of income and expenses that are unusual, non-recurring or not indicative of expected results;
  - income derived from assets that may not be included in the company during the forecast period (i.e. non-operating assets that may be withdrawn from the company before completion of the investment, such as excess cash balances, investment portfolios, art or excess land); and
  - break-even volume for the new product line.
- Estimate sales volume, price and revenue for each product, monthly for the first year and annually between years three and five based on an analysis of future market conditions for your various products.

- Estimate costs for each future period based on forecast sales volume and expected cost relationships. Additional fixed and variable costs associated with forecast growth should be included in the estimates.
- Deduct income taxes based on projected tax rates. If there are significant differences between expenses recorded for accounting and for tax purposes, it may be appropriate to make these adjustments in a separate calculation. The primary adjustment would relate to the difference between depreciation recorded for accounting purposes and capital cost allowance recorded for tax purposes. In addition, the impact of tax losses carried forward should be considered.
- Adjust net income to cash flow from operations by adding back all non-cash charges included in the determination of net income. The main non-cash items are depreciation and amortization.
- Based on your forecast operating cash flow, deduct the following:
  - forecast capital spending based on the capital budget;
  - increase in working capital required to meet the forecast growth in operations;
  - dividends consistent with prospective dividend requirements; and
  - interest payments consistent with existing and proposed lending agreements.
- Add cash inflows not included in cash flow from operations such as interest and proceeds from the sale of assets.
- Finally, the proposed investments should be included in the forecast.

Reasonableness of Assumptions

The assumptions used to prepare your projected financial statements must be stated clearly, reasonably and consistently. For example, ensure:

- your working capital needs, production capacity and personnel requirements are consistent with the level of forecast growth; and
- the level of forecast sales growth is reasonable relative to the expected market growth.

In addition, you should determine if the level of forecast growth requires a significant gain in market share. If so, you should determine if this can be achieved. It may not be reasonable to assume a price increase and a significant increase in sales volume if your market share is competitive and not expected to grow.

Some of the more important quantitative assumptions used for New Tech are given in Exhibit 1.7. The upper portion lists assumptions related to annual sales growth, gross margin as a percentage of sales, selling expenses as a percentage of sales and the amount of money that will be spent on administration, and research and development. These figures are drawn from the income statements (see Exhibit 1.1). Other assumptions have to do with income tax rates, working capital accounts such as the average collection period and inventory turnover (balance sheet accounts), and interest rates for various loans.

> Third-party support for your assumptions may add significant credibility to your forecast.

Sensitivity Analysis

Sensitivity analysis examines the impact of changes on your income after tax and cash flow projections. This exercise is useful because it helps to identify the significance of each assumption in terms of its impact on future financial results. It may also indicate where you need to gather additional information to support your assumptions. This additional information may increase the level of reliability of your estimates and give your investors more confidence in your estimates.

Sensitivity analysis allows you to look at a number of "what if" scenarios. Exhibit 1.8, for example, shows the impact of changes in sales revenue on New Tech's financial performance, particularly as related to gross margin, operating income, income after taxes, the relationship of income after taxes to sales revenue, the company's economic value added, sustainable growth rate and financial health score. The exhibit shows how New Tech's 1999 and 2000 financial performance would change with a 5% (scenario A) or 10% (scenario B) drop in sales revenue. Management can also assess the sensitivity of changes in other key elements such as selling price, costs of goods sold and marketing expenses on the company's financial performance.

Break-even Analysis

Break-even analysis tells you the sales revenue or production levels at which your business will neither make a profit nor lose money. If you know your break-even point, you have a definite target that you can plan to reach through carefully reasoned decisions.

Calculating the break-even point can be simple (for a one-product business) or complex (for a multi-line business) but, whatever the complexity, the basic technique is the same. The break-even point is predicated on the observation that some costs vary in direct proportion to the volume of production, while others remain fixed regardless of the level of output. Variable costs include direct labour and direct material expenses for manufacturing or service organizations, and cost of goods sold (purchases) for retail establishments. Fixed costs refer to such items as rent, office salaries, interest and insurance.

As shown in the income statements (Exhibit 1.1), New Tech expects to realize the following objectives for the year 1999:

Sales revenue	$ 3,900,000
Gross margin	$ 2,435,000
Income before taxes	$ 316,000
Return on assets	9.2%
Income after taxes	$ 205,000
Return on assets	6.0%

Using the information contained in the income statement, it is relatively easy to calculate New Tech's break-even point. In Exhibit 1.9, the information drawn from the company's income statement is rearranged to group all variable costs and all fixed costs under separate categories. This process identifies the company's contribution margin. As shown in the exhibit, New Tech's contribution margin for 1999 is forecast at $2,650,000, which is the difference between total variables costs of $1,250,000 and sales revenue of $3,900,000. As the term suggests, the contribution margin "contributes" or pays for the $2,334,000 fixed costs. As shown, after paying the fixed costs, New Tech would be left with a $316,000 before-tax profit.

In 1999, the company's profit/volume ratio is estimated at 0.68 ($2,650,000 contribution margin divided by $3,900,000 sales revenue). This means that in 1999, New Tech will earn $0.68 in contribution margin for each sales revenue dollar. As shown in the exhibit, to break even, the company has to reach $3,434,943 (fixed costs of $2,334,000 divided by the 0.68 contribution margin) in sales revenue, or 88.1% of its revenue objective.

However, companies are not in business only to break even, they want to generate a reasonable return. As shown in the lower portion of the exhibit, if the company wants to reach a 15% before-tax return (or $517,000) on its assets instead of only 9.2% (or $316,000), New Tech will have to reach $4,195,811 in sales revenue instead of $3,900,000. This number is arrived at by dividing the company's fixed costs and profit objective by the contribution margin ($2,334,000 + $517,000 / 0.68). Similar calculations can also be done for various return objective levels based on total assets, shareholders" equity or invested capital.

Monthly Cash Budget

The instrument used to analyse the monthly flow of cash is called the cash budget. It identifies the cash balances for each month during the forthcoming operating year. It is used to negotiate a line of credit. Exhibit 1.10 shows New Tech's monthly cash budget for 1999. The information used to prepare this cash budget is drawn from the 1999 projected income statement (Exhibit 1.1). As shown, the yearly sales and expense targets are distributed over 12 months.

As a first step in preparing a cash budget, all future receipts from cash sales and collections must be identified for each month. In the second step, all cash disbursements for individual expense items are pinpointed. The difference between the receipts and the disbursements will either give a net cash surplus or a cash deficiency.

Several departmental managers must participate in the preparation of the cash budget, and it requires a certain degree of judgment. For example, the sales department will provide the sales figures, while the credit manager will give a breakdown of the approximate percentage of sales that will be made on a cash basis, on credit and paid within 30, 60 or 90 days. Various departmental heads also provide information on operating expenses related to such things as sales revenue, purchases, wages, salaries and lease payments.

In preparing a monthly cash budget, you should consider the following:

- percentage of cash sales;
- accounts receivable collection — % 30 days, % 60 days, % 90 days, % of bad debts;
- seasonal pattern of sales;
- payment policy/experience (e.g. within 30 days);
- pattern of ordering supplies; and
- other cash receipts/disbursements (wages, interest, taxes, etc.).

The controller subsequently determines the amount of cash that should be kept in the bank at all times (cash at start of month), the amount that should be invested in short-term securities (surplus cash) and the amount that will be required from the bank as a line of credit (loans outstanding). As shown in Exhibit 1.10, when preparing the monthly cash budget, the key items that are important are the receipts and the disbursements.

The cash budget should reflect the cyclical and seasonal fluctuations in sales levels for temporary current assets (i.e. month-to-month fluctuations in cash flow requirements) and the expected timing of the collection of accounts receivable, purchase of inventory and payment of accounts payable. This type of analysis illustrates the monthly fluctuations in cash requirements not shown in the annual forecast.

The cash budget also identifies a company's ending bank balance for each month. In New Tech's case, the ending bank balance for each month shows surpluses from January to March, and deficits from April to December. The deficits are offset by the injection of $200,000 in bank financing and $600,000 in equity financing throughout the year. Note: Some commercial banks supply schedules that may assist you in short-term cash flow planning. Most commercial banks also provide forecasting software packages for preparing cash budgets.

3. Analyse Your Financing Options

Once financial needs have been pinpointed, the next step is to identify financing requirements and the options (or instruments) available to meet your specific needs. Financing instruments include conventional financing instruments and risk capital financing instruments.

When selecting a specific source of financing, it is important to appreciate that each bears a different cost. Risk is the key to determining how much it will cost to finance your investment needs. There is a direct relationship between risk and return. Risk (the investment opportunity) and the rate of return (expected by investors) go hand in hand. As risk goes up, so must the rate of return to compensate for the additional risk assumed by the investor.

Before exploring the various financing options, let's define the three types of risks.

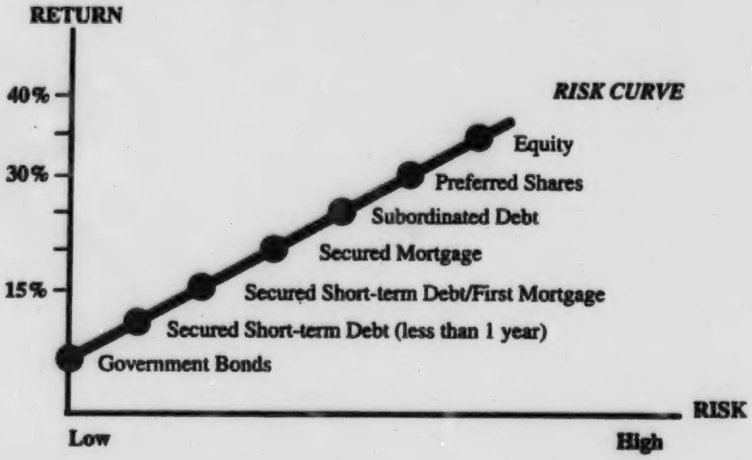
Business risk. The predictability, stability and level of future net cash flow — the uncertainty inherent in forecast cash flow.

Financial risk. The amount of financial leverage — the level of claims on net cash flow (i.e. interest, coupons, royalties).

Instrument risk. Secured versus unsecured, quality of security, demand versus permanent, liquidity, control features.

When risks are high, the financing instrument must offer a corresponding high rate of return to attract investors. Figure 1.2 shows the risk curve, that is, the relationship between risk and return. As shown in the figure, financing instruments, based on their specific characteristics (security, claim on cash flow, liquidity/marketability and pricing), can be placed at different points on the risk curve.

Figure 1.2
Financing Options (Risk versus Return)



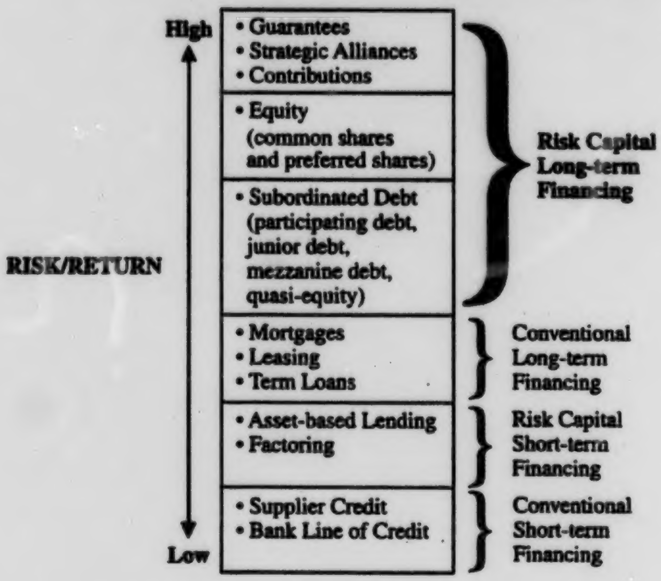
Although equity appears to command a high return, for a growing company it is often the most stable and appropriate source of capital. If the company is dealing with a risk capital investor, the annual cash cost for the equity may be reasonable to a company because it is the market (i.e. initial public offering) that will pay the price at "take out" time, that is, when the investor exits the company.

The Identify Potential Investors module presents the same risk curve to show the risk/return preferences of risk capital investors.

Conventional financing, which is generally provided by commercial banks, credit unions and trust companies, tends to accept a relatively low return because the risk related to the investment is low. These loans are guaranteed by collateral or guarantees. In contrast, investors in risk capital tend to invest in projects with higher levels of risk and, for this reason, will demand a higher rate of return. There are a number of sources of risk capital financing including finance companies, founder capital, angel investors, private venture capital firms, institutional and labour-sponsored funds, and government and corporate strategic investors. These sources are described in detail in Identify Potential Investors.

Figure 1.3 presents a spectrum of conventional and risk capital financing instruments, ranging from the least to the most risky. The figure also illustrates short- and long-term conventional and risk capital financing instruments.

Figure 1.3
Conventional and Risk Capital Financing Sources


High
• Guarantees
• Strategic Alliances
• Contributions
• Equity
(common shares
and preferred shares)
• Subordinated Debt
(participating debt,
junior debt,
mezzanine debt,
quasi-equity)
Risk Capital
Long-term
Financing
RISK/RETURN
• Mortgages
• Leasing
• Term Loans
Conventional
Long-term
Financing
• Asset-based Lending
• Factoring
Risk Capital
Short-term
Financing
• Supplier Credit
• Bank Line of Credit
Conventional
Short-term
Financing
Low

This section describes the meaning of various financing instruments including their advantages and disadvantages.

Conventional Short-term Financing
- Bank line of credit
- Supplier credit

Risk Capital Short-term Financing
- Factoring
- Asset-based lending

Conventional Long-term Financing
- Term loans
- Leasing
- Mortgages

Risk Capital Long-term Financing
- Subordinated debts
- Equity

> If you are familiar with these financing instruments, you might want to proceed to the discussions in section 4 of this module, Capital Structure and Mix.

Before getting into the details of the various financing sources, let's review how much New Tech has to raise from the various lenders and investors. The $1,575,000 financing needs for 1999 are made up of the following.

Financial needs	
Working capital requirements	$ 200,000
Capital assets	1,100,000
Marketing costs	225,000
Cushion	50,000
Total	**$ 1,575,000**

Let us now look at New Tech's financing requirements, that is, where funds will have to be obtained to finance these needs. The following amounts are drawn partly from the statement of changes in financing position (Exhibit 1.5). As mentioned earlier, both the marketing costs and, if required, the cushion will be financed by internally generated funds while working capital and capital assets ($1,300,000) will be financed by the following sources.

Financing requirements	
Long-term debt	$ 200,000
Equity	600,000
Internal sources	775,000
Total	**$ 1,575,000**

Exhibit 1.11 shows New Tech's cash flow for its ongoing operations and for additional investments. Specifically, it shows the amount needed to finance its new product line. As shown, the company's short-term financial needs ($274,000) will be financed by suppliers (accounts payable). Conventional short-term financing (term loan and working capital loan) will provide $74,000. The $1,120,000 amount shown in the lower portion of Exhibit 1.11 includes capital assets of $1,100,000: $800,000 to be financed externally (long-term debt of $200,000 and equity of $600,000) and internally generated funds (income and depreciation) of $530,000.

Conventional Short-term Financing ($24,000)

Conventional short-term financing is usually provided by commercial banks and is to be repaid through inventory turnover or by converting receivables to cash within the time frame of the loan. Your bank will lend your business money if it feels comfortable with the risk. These loans can be secured or unsecured. A secured loan is backed by collateral that would be applied to recover the loan in case of default. An unsecured loan is not backed by any collateral. These are almost always short-term loans and available only to the most credit-worthy individuals and companies. The loan is backed by your banker's faith in your character, ability to repay the loan and capital (favourable financial structure). New Tech will obtain $24,000 in conventional short-term financing: a term loan for $15,000 and a working capital loan for $9,000. Let's now look at the various sources of short-term financing.

Bank line of credit

Short-term debt is for short-term needs: seasonal inventory loans, short-run production or construction loans, and short-term liquidity problems. These instruments are also known as operating loans or working capital loans. Total borrowing usually fluctuates, as often as daily, to cover expected cash shortfalls. These credit instruments are designed to finance fluctuating current assets. A bank line of credit is a revolving (fluctuating) credit instrument, with a stipulated ceiling on total borrowing. It works much like a credit card: you arrange before the need arises to have so much credit to draw against, then you pay it off (or renew it). The main thing to avoid is a routine of using new debt to pay for last year's short-term needs — bad enough for an individual, but worse for a small business. Generally, a pledge of current assets (accounts receivable, inventories and marketable securities) supports the business.

A bank may be willing to lend against your current assets provided they are of good quality. It will assess your accounts receivable with regard to age, collectibility and diversification. It also assesses your inventory in terms of turnover and obsolescence and your marketable securities with respect to liquidation and market value.

Here are some of the features associated with conventional financing.

- **Ceiling**
  Typically, total borrowing may not exceed the lesser of the following:
    - the aggregate of 75% of accounts receivable, 50% of inventories and 100% of marketable securities (these margins are indicative only); or
    - some predetermined dollar amount.

- **Terms**
  On demand or committed for a period of less than one year (where demand means the bank can demand repayment at any time, provided is gives "reasonable" time for repayment).

- **Costs**
    - prime plus a margin (depending on the risk of your particular situation);
    - commitment fee (perhaps one half to three quarters of 1% per year on total committed amount);
    - legal costs; and
    - monthly administration fees.

- **Security**
    - specific charges over accounts receivable and inventories;
    - floating charges over all other assets, except real property;
    - documentation (commonly involves a general security agreement at a minimum); and
    - a promissory note to show each borrowing under the facility.

Table 1.1 lists the advantages and disadvantages of a bank line of credit.

Table 1.1: Advantages and disadvantages of a bank line of credit

Advantages

- Easy and fairly quick to access.
- Relatively inexpensive.
- Flexible.
- Facility revolves up and down, maximizes cash management.
- Suitable for short-term temporary needs.
- Usually, reporting requests are minimal.
- Negligible effect on control and ownership.
- Interest/fees are tax deductible.

Disadvantages

- Increases your financial risk, cash servicing required.
- Amount available is limited by the ceiling.
- If you are experiencing problems, lender is in a position to demand/cancel the line, or realize on the security.
- Not suitable for long-term requirements, where you expect returns over a long period.
- You may not have suitable security, or your business/financial risk may be too high.

Supplier credit ($50,000)

Supplier credit is also known as trade financing. Almost all businesses use trade credit. Companies do not pay for their supplies on a cash-and-carry basis. Invoices for materials, supplies and services provided by outsiders are not received until some days after the materials are delivered or the services performed.

Suppliers provide time to pay for orders (e.g. 30 or 60 days). Even better, they may offer cash discounts. A cash discount stated as "2/10, net 30" means you will get a 2% discount, if you pay within 10 days but, in any event, the terms oblige you to pay within 30 days.

As your company grows, supplier credit also grows. Your volume orders will increase, resulting in increased credit. If, for example, your supplier allows 30 days, you can always try to negotiate better terms. Also, examine whether you are fully using your trade credit. Stretching your accounts payable to their maximum provides a one-time source of additional capital.

Note: If suppliers provide a cash discount, you should take advantage of it, even if you have to borrow under your bank line of credit. Consider the following example. Your suppliers provide credit terms of 2/10,.net 30. This results in either:

- **Option A,** where the total cost at 30 days is much higher; or
- **Option B,** where the total cost of paying at 10 days and borrowing the amount of the payment from the bank for the remaining 20 days is less.

The following shows how the calculation is made. Suppose that you purchase $1,000 worth of supplies and have the option to pay in 30 days or to take advantage of your supplier's credit terms of 2/10, net 30. As shown, even borrowing from the bank to pay in 10 days gives a definite economic advantage.

	Option A	Option B
Pay supplier		
@ 10 days		$980.00 (98% of $1,000)
@ 30 days	$1,000.00	
Borrow:		
@ 10 days		($980.00)
Pay bank:		
@ 30 days		$980.00
Interest @ 10% per annum		$ 5.37 ($980 X 20/365 x 0.10)
Total cost	**$1,000.00**	**$ 985.37**

Table 1.2 lists the advantages and disadvantages of supplier credit.

Table 1.2: Advantages and disadvantages of supplier credit

Advantages	Disadvantages
• Very inexpensive source of financing. • Very limited documentation required. • Easy access. • No costs. • No controls. • No security.	• Likely not sufficient to bridge fully the timing difference between paying for supplies and receiving cash from sales. • Very short term in nature. • If you do not pay on time, the supplier might cut off future supplies, which could have adverse effects on your business.

Risk Capital Short-term Financing

Commercial finance companies also provide credit on working capital accounts such as accounts receivable and inventories. These lenders are more concerned with the quality of the underlying collateral than with the credit worthiness of the borrower. Because of their expertise with receivables and inventory-based loans, they can frequently advance to the borrower a higher percentage against the collateral. Let us now look at the various sources of risk capital short-term financing.

Factoring

Under factoring, the business makes an outright sale of its accounts receivable to a finance company. The customer is told that the invoice has been sold and is asked to make payments directly to the finance company. This arrangement clearly increases the lender's risk. To reduce the risk, the finance company virtually takes over the work of the borrower's credit department. All orders received from customers are sent to the finance company, which does a credit appraisal. Factoring is fairly costly.

Factoring involves a continuing agreement under which a financing company, the factor, purchases receivables as they occur. The factor assumes the risk of accounts becoming uncollectable and is responsible for collections. The factor may also perform credit checks on customers.

There are two general types of factoring arrangements.

Maturity factoring. You and the factor agree on an average collection period (e.g. 30 days). Regardless of whether your customer has paid the account at 30 days, the factor will pay you. For example, at the end of 30 days, your customer pays $500 but owes $1,000. The factor will pay you $1,000 less a commission (typically, 0.5% to 1.5% of total face amount). The factor may charge you interest on the outstanding portion of the invoice.

Old-line factoring: The factor will perform a lending function. It will advance money to your company based on 70% to 90% of the value of an invoice. The factor may charge interest at prime rate plus 1% to 1.5% per annum, as long as the invoice is outstanding. In this case, you receive cash almost immediately after you make a sale.

Depending on the agreement, some factors will have recourse against your company (in the event of bad debts). Other debtors will have no recourse.

Table 1.3 lists the advantages and disadvantages of factoring.

Table 1.3: Advantages and disadvantages of factoring

Advantages

- Factors assume the risk of your receivables but not your business/financial risk. Therefore, financing is accessible even if your company's overall risk is relatively high.
- Increases the turnover of your accounts receivable, in turn increasing the amount of available working capital and, therefore, reduces other financing requirements.
- Lowers administrative duties and costs. The factor may assume collection, booking and reporting.
- May protect your company against bad debts.
- Suitable to finance temporary working capital and offset permanent current asset requirements.

Disadvantages

- If the volume of your receivables is low, your situation may not be suitable.
- Relatively expensive, particularly when invoices are numerous and small in dollar amounts
- Not commonly accepted in many industries.
- Not suitable for most long-term needs.
- Possible negative impact on customer relationships.

Asset-based lending

Asset-based lending is another form of risk capital short-term financing. Just like a bank line of credit, an asset-based loan will be subject to a ceiling amount based on receivable and inventory margins. It also involves a security pledge of accounts receivable and inventories. However, pure asset-based loans differ because they rely on collateral coverage rather than being linked directly to financial forecasts. Therefore, business and financial risk are less of an issue with asset-based lenders compared to conventional short-term lenders. However, pricing is higher, and interest may range from the prime rate plus 2% to 5% per annum.

Table 1.4 lists the advantages and disadvantages of asset-based financing.

Table 1.4: Advantages and disadvantages of asset-based financing

Advantages

- Ideal for growing, highly leveraged and turnaround situations, because of the higher level of risk assumed by the lender.
- No complicated financial covenants, which require monitoring and compliance. This results in less chance of default under a loan agreement.
- Given the heavy reliance on the value of the collateral, it increases the opportunity for leverage.
- Lowers the need to raise equity, avoiding equity dilution.
- Interest is tax deductible.
- Easy to access.

Disadvantages

- Not suitable for all industries; needs high levels of receivables and inventories.
- Increases your financial risk, due to interest servicing.
- More expensive than conventional short-term financing.
- Onerous inventory and receivables monitoring requirements, sometimes as often as daily.

Conventional Long-term Financing

Capital assets are often financed by intermediate and long-term funds. These may be straightforward term loans, usually secured by the capital asset itself. Equipment vendors and leasing companies also provide financing through leasing arrangements. Lending institutions such as life insurance companies, commercial finance companies, pension funds, and federal and provincial government agencies provide longer financing on capital assets.

Term loans ($200,000)
Term loans are the principal form of medium-term financing (i.e. three to seven years). However, in certain circumstances, the maturity may be as long as 15 years. A term loan involves an agreement whereby a borrower agrees to make a series of interest and principal payments on specific dates to a lender. This differs from a bank line of credit, where repayment is at any time (demand) or at a specified time, in one lump sum. As shown in Exhibit 1.11, New Tech will borrow $200,000 from long-term conventional lenders.

Lenders include banks, trust companies, insurance companies and pension funds. The Business Development Bank of Canada also provides these types of loans. The maturity profile will depend on the lender, life of the asset being financed, and the borrower's capacity to repay the loan. Insurance companies and pension funds prefer larger periods of maturity. A commercial bank's time frame tends to be five to seven years.

Repayment could be based on equal instalments at regular intervals. You may choose to tailor your repayment instalments to suit a particular situation.

Longer term loans make this financial instrument riskier than bank lines of credit. Therefore, the banks will typically levy higher interest charges.

Types of security for term loans may include:

- specific charge over fixed assets;
- floating charge over all assets;
- mortgage over real property;
- debentures; and
- mortgage bonds.

Table 1.5 lists the advantages and disadvantages of term loans.

Table 1.5: Advantages and disadvantages of term loans

Advantages	Disadvantages
• Longer repayment terms. • Easy access. • Flexibility. • Tax deductibility of interest. • Suitable for long-term needs: permanent current assets and fixed assets. • Low cost relative to other long-term sources of financing. • Commits the lender for a long term. • Does not dilute equity.	• Ties up your assets. • Increases your financial risk given the cash payments of interest and principal. • Commits you: prepayment will be subject to penalties. • Often includes restrictive covenants. • You may not have suitable security to offer, or your business/financial risk may be too high.

Leasing

Many businesses lease assets as an alternative to owning them. Conceptually, leasing is similar to borrowing money to buy assets. In either case, the business has the use of the asset and incurs an obligation either to pay off a loan or to meet a monthly lease payment. The major difference, of course, is that if the business leases, the asset is owned by the lessor rather than by the business.

There are three types of lease arrangements.

Direct leasing involves a firm that acquires the use of an asset for an agreed-upon series of cash payments.

Sale and leaseback involves the firm selling an asset such as a building or equipment that it already owns and then leasing it back. From the perspective of the lessee firm, this transaction provides an inflow of cash on the sale of the assets and also allows the lessee to use the asset.

Capital leases involve a third party to the lessee and lessor. The added party is a lender who helps to finance the acquisition of the asset to be leased. Under this arrangement, payments of principal and interest are made at equal intervals in equal amounts. In many cases, the lessor will retain ownership of the leased asset at the end of the lease.

Table 1.6 lists the advantages and disadvantages of leasing.

Table 1.6: Advantages and disadvantages of leasing

Advantages

- Up to 100% of the asset cost can be financed.
- Terms may be longer than term loans because you can tailor the lease to the life of the asset.
- Maintenance and other services are provided.
- Cancellation options are available. This may be beneficial where technology is advancing quickly.
- Lease payments are tax deductible.
- The cost may be comparable to a term loan (the lease payments will include an implied rate of interest), but the legal cost to set the lease up should be less.
- Limited restrictive covenants.
- Does not dilute equity.
- Flexibility. You may have limited needs (e.g. two years) but the asset life is less than 10 years. You can structure the lease around your limited needs.

Disadvantages

- If you default on your payments, it is quite easy for the lessor to walk in and legally remove a potentially critical piece of equipment used in your operation since the lessor owns the equipment.
- Increases the financial risk due to the fixed stream of cash payments.
- Cancellation costs are high.

Mortgages

Generally, mortgages are used to finance real property such as land and buildings. Mortgages are long-term financing arrangements (e.g. 25 years). The amount of the mortgage will be calculated based on the market value of the property. For example, 75% of the market value might be a common assessment, but you can find companies that will finance up to 90% of the value of the asset. They include mortgage companies, insurance companies and pension funds. These investors frequently prefer long maturity periods. They usually base repayment on equal blended payments of interest and principal. Interest rates will be fixed for specific terms and will depend on the going market rate, the length of the term and availability.

Table 1.7 lists the advantages and disadvantages of mortgage financing.

Table 1.7: Advantages and disadvantages of mortgage financing

Advantages

- Long-term commitment, without equity dilution.
- Maturity matches the long life of the asset.
- Interest is tax deductible.
- Relatively inexpensive source of long-term financing.
- Easy to access.
- Considers the value of the asset, more than the value of the business.
- Standard documentation requirements. Restrictive covenants will be basic.

Disadvantages

- Fairly rigid instrument.
- Increases financial risk due to fixed stream of interest and principal repayments.
- Committed, repayment will hold penalties.

Risk Capital Long-term Financing

Risk capital investors invest funds in equity shares and equity-related debt in relatively small or untried enterprises thereby absorbing much of the risk that commercial lenders are unwilling to shoulder. These investors are rarely interested in inventions requiring further research, development and engineering. It is important to consider that many of these types of investors have certain preferences about the companies they want to back. These preferences are usually based on the type, history and status of the company and the amount of financing needed.

Risk capital long-term investors prefer dealing with companies whose products are already selling and are proven successes but which lack the capital to exploit their markets. Generally, these investors have excellent contact in the credit markets and a highly refined sense of how to structure a deal. Risk capital investors provide debt and equity financing.

Subordinated debt

Subordinated debt is a risk capital term debt. Subordinated debt investors accept a higher level of risk, compared to conventional sources. Alternative titles for subordinated debt include:

- participating debt;
- junior debt;
- mezzanine debt; and
- quasi-equity.

These instruments levy a rate of interest that typically ranges from 8% to 12%. However, the overall rate of return to the investor will be higher. Participation features augment the rate of return, and the expected return ranges between 15% and 25% per year. Effectively, investors structure the instrument to share in the expected success of the company. Some examples include:

- royalties (percentage of net cash flow generated from operation);
- participation fees;
- normal cost of common shares;

- warrants or options to purchase shares; and
- rights to convert debt into common shares.

Subordinated debt financing is a good option to explore if you have exhausted secured financing (i.e. term loans based on capital assets, or short-term financing based on current assets, are not available). Subordinated debt is better suited to:

- rapidly growing companies;
- expansion programs;
- management and leverage buyouts; and
- acquisitions.

Subordinated debt instalments can be tailored to the characteristics of an individual transaction. Therefore, the risk of borrower default is less compared to conventional long-term sources of financing. For example, the instrument may accommodate:

- a subordinated position to a term lender;
- low cash interest commitments; and
- principal payments in a lump sum (e.g. 10 years down the road), tied to performance or waived entirely if the debt is converted to equity.

Sources of subordinated debt include private sector venture capital firms, institutional investors, labour-sponsored funds and government corporations. For more information, refer to the Identify Potential Investors module.

Other typical characteristics of subordinated debt may include:

- interest coupons of 8% to 12%;
- terms of five to seven years;
- amounts of $250,000 to $10 million; and
- security subordinated to senior lenders.

A significant portion of an investor's return will depend on the value of the company's shares at some point in the future. As a result, the following will be of interest to the subordinated debt investor:

- proven management capabilities;
- established historical cash flows;
- ability to pay interest coupons;
- stability of the industry;
- minimum future capital expenditures;
- market niche;
- competitive barriers, including trademarks or patents; and
- having a comprehensive investment proposal.

(Source: *The Canadian Business Financing Handbook*)

Table 1.8 lists the advantages and disadvantages of subordinated debt.

Table 1.8: Advantages and disadvantages of subordinated debt

Advantages

- Flexible and can be tailored.
- Less expensive than equity.
- Fills a financing gap and high leverage is available.
- Not as much dilution as straight equity.
- Available to a variety of industries.

Disadvantages

- Takes time to access.
- Expensive relative to other sources of short- and long-term financing.
- Some cash flow servicing requirements.
- Investors will take a more active role in your company than other lenders.
- Set-up costs are high.
- Restrictive covenants often apply.
- Does not provide the stability of equity.

Equity ($600,000)
Equity is the interest in your company held or owned by shareholders. Equity is the amount available to shareholders after you have paid all creditors and lenders. As shown in Exhibit 1.11, New Tech anticipates raising $600,000 from risk capital investors. It is important to note that a liability is a fixed obligation that obliges you to pay it back. With equity financing, there is no fixed repayment requirement. This form of financing can be very beneficial to a growing company because there is typically little ongoing cash cost. Often, the exit strategy for investors involves selling their stake to the market at no cost (other than opportunity cost) to the company.

Equity ownership is one of two basic types.

Preferred Shares. Long-term to permanent equity paying a fixed dividend; likely non-voting; ranks in front of common shares in liquidation or bankruptcy.

Common Shares. Permanent equity; voting; no dividend commitment; ranks last.

An important aspect of equity is that it represents the ultimate business risk. The risk curve, presented in Figure 1.2 on page 18 shows equity at the greatest risk level and, therefore, demands the greatest return. Risk capital private equity sources (founders, angels, private sector venture capital firms, institutional investors, labour-sponsored funds, government corporations) typically seek returns ranging from 25% to 40% per year. For more information, refer to the Identify Potential Investors module.

The required return on equity is relative to the percentage ownership of shares. It is not simply a proportionate share of annual profit and accumulated retained earnings. More accurately, it relates to the present value of future cash flows. For more information, see the Demonstrate Your Investment Potential module.

Initially, there must be sufficient equity capital to start up a company and its operations. However, equity financing can also finance:

- growth — current assets and capital asset requirements;
- plant and equipment expansion;
- introduction of new product lines;

- research and development;
- bridge financing before going public;
- acquisitions/management and leveraged buyouts (MBOs and LBOs); and
- restructuring/refinancing.

Other sources of equity financing include:

- government programs (i.e. contributions);
- strategic alliances with corporate strategic investors (these alliances are discussed in the Identify Potential Investors module); and
- guarantees provided by owners, government or other third parties. (Essentially, a guarantee provided to enhance the credit-worthiness of a financing instrument is a potential equity contribution.)

Table 1.9 lists the advantages and disadvantages of equity financing.

Table 1.9: Advantages and disadvantages of equity financing

Advantages	Disadvantages
• Low financial risk. No obligations for cash payment. • No restrictive covenants that could cause default. • Provides stability and permanency. • Investors generally seek to realize on their equity investment in the marketplace (i.e. at no cash cost to the company).	• Dividends are not tax deductible. • Dilutes your equity interest. • Takes time to access. • Loss of voting and, potentially, management control. • Set-up costs are high.

4. Capital Structure and Mix

Up to now, you have determined the amount of financing you require, the characteristics of your requirements (i.e. short and long term) and alternative financing instruments. The next step is to focus on answers to the following key questions.

- How much of the amount required can you fund internally or conventionally?
- How much will need to be funded externally with risk capital?
- How do you choose the appropriate instrument and capital structure for your company?
- What mix of debt to equity should you choose?

Capital Structure

Capital structure refers to the proportion of debt in relation to equity used to finance assets. There are three basic approaches to selecting an appropriate capital structure, related to the maturity of the financing need (i.e. short versus long term) and the life of the assets.

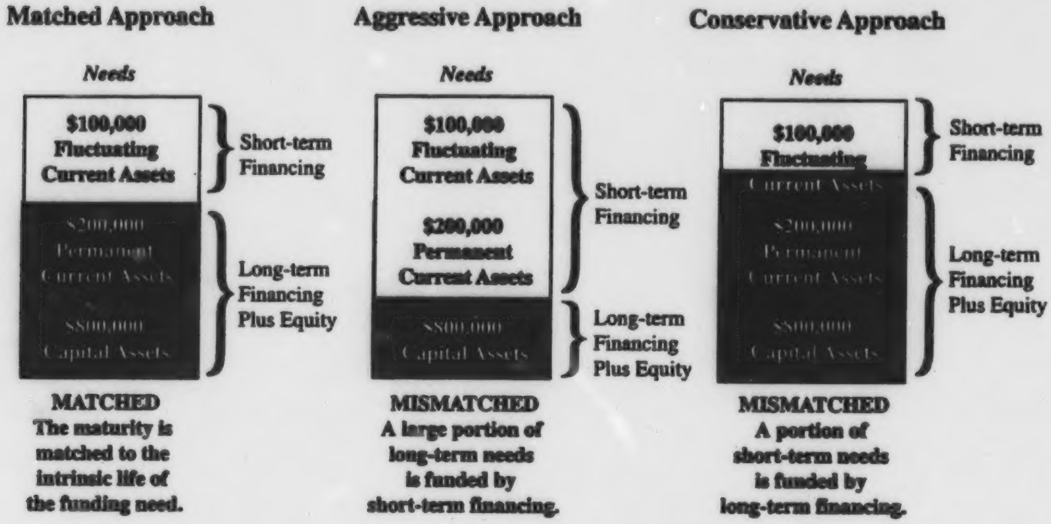
Matched Approach. Short-term financing instruments are used to finance short-term fluctuating needs, and long-term financing (i.e. debt and equity) is used to finance permanent working capital and capital asset requirements.

Aggressive Approach. Short-term financing is used to finance both fluctuating and permanent working capital needs.

Conservative Approach. Long-term financing (i.e. debt and equity) is used to finance fluctuating and some permanent working capital needs.

To illustrate the differences in these approaches, consider a company that wants to purchase $1 million in assets: $100,000 to fund fluctuating current assets (short term), $200,000 to fund permanent current assets (long term) and $800,000 to finance capital assets (long term). Figure 1.4 presents the difference between the three approaches and how the company could finance the purchase of these assets.

Figure 1.4
Capital Structure


Matched Approach
Needs
$100,000 Fluctuating Current Assets
$200,000 Permanent Current Assets
$800,000 Capital Assets
Short-term Financing
Long-term Financing Plus Equity
MATCHED
The maturity is matched to the intrinsic life of the funding need.
Aggressive Approach
Needs
$100,000 Fluctuating Current Assets
$200,000 Permanent Current Assets
$800,000 Capital Assets
Short-term Financing
Long-term Financing Plus Equity
MISMATCHED
A large portion of long-term needs is funded by short-term financing.
Conservative Approach
Needs
$100,000 Fluctuating Current Assets
$200,000 Permanent Current Assets
$800,000 Capital Assets
Short-term Financing
Long-term Financing Plus Equity
MISMATCHED
A portion of short-term needs is funded by long-term financing.

Mix

In addition to capital structure, you should consider the mix of debt to equity. Strategies can be grouped under the following.

Low Leverage. Mainly equity investment funds are the bulk of your financing needs.

Medium Leverage. The mix balances debt and equity fairly.

Highly Leverage. Mainly debt instruments fund the bulk of your financing needs.

The following example shows how a company makes a decision on its mix of debt and equity financing. The company is buying equipment worth $900,000 and needs additional permanent working capital of $100,000. The useful life of the equipment is 15 years.

Here is the company's net cash flow forecast ($000).

	Time Zero	Year 1	Year 2	Year 3	Year 4	Year 5
Net cash flow	($1,000)	$200	$200	$200	$200	$200

The following assumptions are used to calculate the cash flow forecasts for the three options:

- term debt @ 15%;
- subordinated debt @ 10%; or
- equity.

1. High leverage: 100% debt
   - $675,000 (term debt)
   - $325,000 (subordinated debt)

2. Medium leverage: 60% debt/40% equity
   - $600,0000 (five-year term debt)
   - $400,000 equity

3. Low leverage: 100% equity
   - $1,000,000 equity

The cash flow results for each strategy follow.

High leverage ($000)	Year 1	Year 2	Year 3	Year 4	Year 5
Net cash flow	$200	$200	$200	$200	$200
Interest	(134)	(122)	(110)	(95)	(80)
Cash available for debt repayment	66	78	90	105	120

Medium leverage ($000)	Year 1	Year 2	Year 3	Year 4	Year 5
Net cash flow	$200	$200	$200	$200	$200
Interest	(90)	(75)	(60)	(40)	(20)
Cash available for debt repayment	110	115	140	160	180

Low leverage ($000)	Year 1	Year 2	Year 3	Year 4	Year 5
Net cash flow	$200	$200	$200	$200	$200

In this particular case, management would choose the medium leverage scenario for the following reasons.

- The $600,000 term loan was two-thirds the value of the equipment.
- Total cash flow available to repay debt was $715,000 against the $600,000 term loan, given a 19% margin.
- The life of the asset extends to 15 years, leaving 10 years to provide a return on the equity.
- There is insufficient cash flow in the high leverage situation to repay the term loan in five years. This scenario is far too risky.
- With $200,000 net cash flow each year, the company would not want to dilute its equity position to the degree required under the low leverage scenario. It is satisfied with taking on more risk through leveraging.

Rules of Thumb When Determining Structure and Mix

Consider the following rules of thumb when choosing the structure and mix for your company (i.e. risk capital versus other financing options).

- As the risk of the investment goes up, the investor will require a higher rate of return. The shift of risk from your company to the investor increases the cost to your company. However, if equity risk capital is raised, there is generally little cash cost to the company because the investor will hold the equity for a number of years and then sell the shares in the market place. Of course, there is an opportunity cost (i.e. the value of the shares when they are sold). The company may have been better off with more equity, but this is often offset by the additional benefits equity risk capital provides to a growing company.

- As risk of the investment goes down, the investor will require a lower rate of return. This means the company is assuming a higher risk at a lower cost.

- The lowest cost instruments are short-term financing instruments, but they hold the highest level of risk from your company's perspective.

Sources of Funds

As mentioned earlier, you will need to determine the amount you can finance through internal and external conventional sources. In New Tech's case, the amount is $975,000 (see Figure 1.1 on page 4). The remainder of this module discusses the amount of risk capital financing required ($600,000) by the company in the example.

First, identify the range of financing options available from conventional sources based on your view of the following items.

Internal

Determine the funds available based on increasing efficiencies in your business, for example, lowering accounts receivables and inventories in addition to negotiating better terms with suppliers. In New Tech's case, $775,000 (see Figure 1.1 on page 4) in internal funding will help finance its investment opportunity (working capital requirements, advertising and promotional campaigns for the new product line, and capital assets).

External

It is important to determine the amount of conventional financing you are able to obtain given constraints related to the conventional financing. For example, the bank will:

- place restrictions on the size of an operating line of credit;
- restrict the advance rate (percentage allowed) on accounts receivable and inventory balances to calculate the maximum line of credit (e.g. 75% on accounts receivable, 50% of inventory); and
- limit the amount of term debt allowed given performance requirements and advance rates.

In the New Tech example, $24,000 in conventional working loans and $200,000 in long-term debt financing are required. Once the amounts of internal and conventional financing are finalized, the remaining requirement will need to be funded using long-term risk capital financing. At this point, you need to consider your overall capital structure.

Ultimately, it is up to you to evaluate the structure and mix options, and determine which approach is the most appropriate.

5. The Entrepreneur's Needs

Which approach — matched, aggressive or conservative — is best suited to your company? Which mix of short or long term, debt or equity, best meets your needs, goals and constraints? Is high leverage or low leverage more suitable? The answers depend on several factors. To assist you with selecting your preferred capital structure, consider the following.

Costs. The more debt you assume, the bigger your fixed cash servicing burden. However, the actual cost of debt is lower than the cost of equity.

Risk. If you add more debt to your company, you are adding risk because you are committed to scheduled interest and principal payments. Also, there may be financing covenants. If you default on a loan agreement, the lender may force you into liquidation or bankruptcy.

Options to protect your downside risk. Consider using more equity if you are in a cyclical industry. If your company or project is very sensitive to increases in interest rates consider using fixed rate, long-term financing or interest rate protection products. If you have a ratchet clause as part of your financing agreement, protect your downside risk. Ensure there is a ceiling on the equity the investor can own if you do not meet your projections.

Relationship with third parties. A private equity investor will likely want greater management and decision-making involvement in your company. Some debt arrangements hold onerous reporting requirements (e.g. asset-based lenders may monitor your inventories and receivables as often as daily). Can you live with these kinds of arrangements?

Collateral. Providing assets for collateral ties up the asset for future financing. If an asset secures debt, the lender might seize that asset in the event of default. The leasing option is particularly vulnerable in this respect.

In addition, you need to identify constraints that may preclude a particular financing instrument or capital structure strategy. Consider some of the following.

Contractual constraints (examples only)

Debt covenants. You may have an existing loan agreement that stipulates a certain debt/equity ratio, e.g., not to exceed 1:1. If you are considering raising more debt, will you remain within this financial ratio constraint?

Shareholders agreements. These agreements may include do's and don'ts. For example, it may state you cannot raise additional equity investment without the consensus of all the shareholders.

Other pre-existing deals and commitments. In a strategic alliance with a corporation, for example, the corporation may restrict you from dealing with any of its competitors.

Non-contractual constraints

For example, physical location may preclude certain sources of financing. Another constraint may be timing. If you need the money today, equity might not be a viable option because it takes longer to access.

Shareholders' control and partnership issues

Perhaps you want to maintain voting control (i.e. 51%). While this may rule out equity as an option, generally, it does not, because most investors only want a minority interest. They want you to run the company.

Family or succession issues

An equity investor might want one of your relatives out of the company because the investor has a better candidate. Perhaps you plan for your children to take over the business. An equity investor may not agree to this.

Lifestyle requirements

Will an equity investor cut out certain "perks" like those golf games on Fridays?

6. The Investor's Needs

Once you have factored your needs, goals and constraints into the capital structure and financing equation, the third consideration is the availability of your desired funding instruments. This will depend on the investor's perspective.

Will your investment opportunity meet a prospective investor's criteria? To assess this, consider the following.

- Determine if your company can generate a sufficient rate of return on the investment (an equity investor will usually require a minimum return of between 25% and 40% per year). Assess if the rate

of return is appropriate with the overall level of risk. Refer to the Demonstrate Your Investment Potential module.
- Different investors require a certain level of profit sharing, management involvement and decision making. You must determine what you are prepared to relinquish and at what level. Potential investors often require some level of involvement.
- There must be a plan for the investor to exit. High-risk investors, at some point, want to gain from their investment. The nature, timing and liquidity of this exit plan must be consistent with your perspective.
- In raising equity, it is prudent to establish a shareholders' agreement to define your roles and any restrictions. It will also help to avoid any future misunderstanding. Refer to the Negotiate the Deal module.
- Mandatory requirements. Assess whether there are any legal or legislative restrictions that make you and a potential investor incompatible. Refer to the Build an Investment Proposal module.

If any of these factors pose a threat to concluding a mutual agreement, it is better to identify this in advance before everyone wastes their time, especially you.

7. Conclusion

In this module, you have taken the first major step to become investor ready. You looked at:

- how to calculate the amount of financing you need;
- the types of financing instruments available to you;
- some available options in terms of approaches to capital structure and mix; and, finally,
- how to consider your business needs in contrast to the needs of potential investors.

In the next module, Demonstrate Your Investment Potential, you will take the second step to becoming investor ready by investigating how you can logically and concretely demonstrate your company's ability to capitalize on your potential.

Case Example

This case example allows you to follow a fictitious company, New Tech Distributors Corp. (New Tech), as it seeks risk capital to finance its growth. The case shows how New Tech addresses the key elements presented in the Details *section of each module.*

If you have not already done so, read about New Tech's background and the challenges it faces in the Steps to Growth Capital Overview. As well, you may wish to refer to the overview for an introduction to the overall structure of this program.

Much of the financial information provided in this case example has already been presented throughout this module. The purpose of reviewing the information one more time is to illustrate how financial needs and financing requirements can unfold within the context of a simulated company story.

This case will help you decide how much financing New Tech needs and the sources it might use to obtain its financing. You should refer to the Establish Your Financing Needs and Analyse Your Financing Options sections of this module for a detailed explanation and calculations about New Tech's financial statements. Specifically, you should refer to exhibits 1.1 to 1.11 as you work out New Tech's financial needs and financing requirements.

The Preparation

Although Stuart Chip hired a financial advisor, Grant Agent, to help determine the financial needs and financing requirements in preparing an investment proposal, he wants his managers to do most of the initial work. Grant's role is to ensure that New Tech is on the right track. Stuart realizes that, as he gets into the more technical parts of the investment proposal, such as business valuation, he will have to rely more extensively on Grant's experience and knowledge. However, Grant suggests that the company should retain a lawyer to ensure that whatever method used for raising funds conforms with securities regulations.

Stuart is very encouraged about New Tech's expansion program and its capability for producing power modules. He feels that the market is growing rapidly and that power modules would provide New Tech with higher margins that would help improve the company's financial performance. He points out that the key to New Tech's future growth and success is to market new highly profitable power modules.

Stuart asks Elizabeth Pratt (New Tech's accountant) to take the lead in this project. However, because of the importance and complexity of this proposal, he wants Elizabeth to get as much information as possible from the company's management team to help her out in preparing the first draft of the investment proposal.

The first thing Elizabeth wants to do is formulate New Tech's financial projections based on the company's objectives and plans. After several months of discussions with the key members of the management team, she was able to prepare income statements, statements of retained earnings and the balance sheets for three years. Exhibits 1.1 to 1.11 present the company's 1998 actual financial results and the 1999 to 2000 projections. Because of market valuation, Elizabeth understands that she will have to extend these projections by another three years, that is, up to 2003. These projections will be presented in Module 2, Demonstrate Your Investment Potential. After reviewing the financial projections, Stuart is of the opinion that the forecast is realistic. He feels that the market would support the estimated price and profit margins.

As shown in Exhibit 1.1, New Tech's sales revenue is expected to grow from $3,000,000 in 1998 to $4,700,000 by 2000, which reflects the introduction of the new product line in 1999. The new product line is also expected to generate substantial increments in income after taxes (from $204,000 in 1998 to $548,000 by 2000).

Exhibit 1.2 presents New Tech's statements of retained earnings. The company pays a small amount of dividends during the forecast period, allowing retained earnings to grow from $654,000 in 1998 to $1,277,000 by 2000.

Exhibit 1.3 presents New Tech's balance sheets. The new line will cost $1,100,000 in 1999 (see increase in gross capital assets line between 1998 and 1999). This would increase New Tech's production capacity. John Harley (sales manager) needs $225,000 in marketing costs (mostly in direct mail advertising) to launch the new product line successfully. These expenditures are included in the 1999 expenses as selling expenses (Exhibit 1.1). Elizabeth also pinpoints that the 30% increase in sales revenue in 1999 would require additional investments in working capital. As shown in the 1999 balance sheet, an additional $100,000 and $75,000 will be invested in accounts receivable and inventory, respectively, but would be partly financed by a $50,000 increase in accounts payable.

The Bank

New Tech's bank will lend only a very small amount to the company on its accounts receivable and inventories. Much of the financing for these working capital accounts will be provided by suppliers. As shown on the balance sheet, in 1999, trades payables will finance about 61% of the company's accounts receivable and inventories. The bank manager will extend the term loan to $140,000 and the working capital loan to $59,000.

When Elizabeth met New Tech's banker, Ted Mooney, for the first time, he clearly stated that the expansion program contemplated by New Tech was considered too risky for the bank and that it could not cover the entire financing package. Mooney explained that the bank does not finance high-risk projects and that other sources of financing would have to be obtained from risk capital investors. Mooney also pointed out that the bank would finance part of the capital assets and working capital accounts, but not the marketing costs and the cushion. The bank would be prepared to provide a loan of $200,000 to finance the production line (long-term credit). This would be a five-year term loan, with annual payments bearing an annual 10% interest charge. The bank is also prepared to increase its term loan by $15,000, and the working capital loan by only $9,000. Mooney also indicated that the company's track record has not been proven enough and was not convinced about the validity of the information contained in the forecast. Mooney's main concern is the lack of management experience in managing a fast-growth business. He emphasized the point that Stuart's experience has always been in managing a division of a larger company.

Exhibit 1.4 and Exhibit 1.5 present detailed information about New Tech's sources and uses of funds for 1999 and 2000.

The Financial Needs

To launch the new product line, Elizabeth indicated that the costs or investment required by New Tech would be as follows:

Cost of the new line	$ 1,100,000
One-time marketing costs estimated	225,000
Additional working capital	200,000
Cushion	50,000
Total financial needs	**$ 1,575,000**

Included in the $200,000 additional working capital are:

Increase in accounts receivable	$ 100,000
Increase in inventory	75,000
Increase in working capital needs	**$ 175,000**

Elizabeth realizes that the investors will be asking many questions about the assumptions used for determining the working capital needs and the numbers shown in the financial projections. For this reason, with the help of the management team, she formulated New Tech's financial objectives related to its liquidity, leverage, management and profitability. These financial ratios are presented in Exhibit 1.6.

Elizabeth also realizes that the investors will want to explore the more important key assumptions used by management to determine their sales revenue and expenses for the three-year forecast. In particular, she knows that risk capital investors will be asking financial projections based on a sensitivity analysis to determine the impact of various assumptions on New Tech's projected financial results. For this reason, she decided to produce several financial scenarios to determine how variations to key assumptions would impact the company's profit and cash flow financial projections. Exhibit 1.7 presents New Tech's key assumptions. The management team also prepared a sensitivity analysis using 5% and 10% reductions in sales revenue. The management team was interested in seeing the effect such drops in sales revenue would have on New Tech's financial performance, particularly as it relates to profitability, its sustainable growth rate, financial health and return on investments. Exhibit 1.8 presents this sensitivity analysis.

In preparing her forecasts, Elizabeth recognizes that New Tech may be eligible for government assistance through tax credits on the research and development expenses for product development. She looks into this by accessing Revenue Canada's Web site (**http://www.rc.gc.ca**). The roles are very complex and she would have to consult with a tax advisor to review this calculation. She plans to include the effects of these estimated tax credits. She knows that if her calculations for the credit amounts and timing of receipt are not accurate, they would affect the total amount of financing required by New Tech.

After reading the regulations, she is of the opinion that New Tech is eligible for a refundable investment tax credit on the current expenditures undertaken to develop the power modules, the assembly line and future products.

The Financing Sources

Her next step is to determine how much of the $1,575,000 would be financed by New Tech's internal sources (i.e. cash flow from operations, supplier credit), external conventional financing sources (i.e. bank operating line or term debt), and risk capital or non-conventional sources (i.e. subordinated debt or equity). Of this amount, $275,000 (the one-time marketing costs and the cushion) will be financed by internal sources. The marketing costs and the cushion are already included as expenses in the 1999 income statement.

She estimates that the financial needs would be financed by the following sources.

Financial needs		$ 1,575,000
Marketing costs and cushion financed by internal sources		275,000
Amount to be funded		**$ 1,300,000**
Financing requirements		
Internally generated funds	$ 476,000*	
Term loan	15,000	
Working capital loan	9,000	
Long-term debts	200,000	
Equity	600,000	
External and internal cash flow		**$ 1,300,000**

**This figure can be obtained by completing the statement of changes in financing position*

To summarize, New Tech's investment strategy is expected to be funded as follows.

Cost or Investment Required	**Total Cost**	**Internal Cash Flows**	**Debts**	**Risk Capital**
New Line	$1,100,000	300,000	$200,000	$600,000
Marketing costs	225,000	225,000		
Additional working capital	200,000	200,000		
Cushion	50,000	50,000		
Subtotal	**$1,575,000**	**$775,000**	**$200,000**	**$600,000**

As mentioned earlier, the marketing costs and cushion are already included in New Tech's 1999 income statement and would therefore be financed by internally generated funds. The $200,000 debt is a long-term loan used to purchase capital assets, and the $24,000 is made up of a $15,000 increase in a bank term loan and $9,000 in working capital.

Elizabeth also had to prepare a detailed monthly cash budget for 1999. This cash budget is presented in Exhibit 1.10.

Another element of the proposal that Elizabeth felt was important to calculate was New Tech's break-even point. Before making this calculation, Elizabeth had to discuss with the production manager the level of production that would be required to cover the fixed and variable costs associated with the new line. To calculate the break-even point, she also required information about the expected unit selling price, expected sales volume, and the marketing variable and fixed costs. She also had to go through each item on the income statement and classify all costs under two categories: variable and fixed. After going through this exercise with various operating managers, she figured out that, in 1999, total variable costs would amount to $1,250,000 and fixed costs, to $2,334,000. Exhibit 1.9 presents this information. Elizabeth also prepared a detailed sheet summarizing New Tech's financial needs and financing requirements for 1999. This information is presented in Exhibit 1.11.

The Financing Package

Elizabeth was now ready to go over the numbers with Grant to determine the reasonableness of the assumptions, financial projections and various sources of funds. She discussed with Grant the pros and cons of non-conventional, long-term financing and what capital structure would be most appropriate. Grant examined the pros and cons of equity participation versus a subordinated debt investment from risk capital investors, and decided on equity because he considered this to be a long-term investment and believed that the company would not have to make interest or principal payments each year. Grant realized that at this stage of the company's growth, New Tech should be in a position to reinvest the maximum earnings back into the business in order to fuel its growth for the next several years. This is what equity funding (instead of debt) would help the company realize.

Grant was also aware that although the cost of equity would be on the high side (investors typically seek a return between 25% and 40% per annum), the cost would not have to be paid by the company on an annual basis. The high return expected by the risk capital investor would be earned at exit through a buyout situation or an initial public offering.

Grant also pointed out that subordinated debt may be a cheaper alternative; however, it would likely be difficult to raise these funds given the short track record of the company and the perceived volatility of the industry.

Elizabeth now knows where she is headed. The bank will cover part of the expansion, but most of the investment would come from outside equity. She calls a meeting of the management team and circulates exhibits 1.1 to 1.11 in advance, together with a memo on the proposed capital structure, the pros and cons of equity and subordinated debt financing.

Author's Note:

What has New Tech Distributors Corp. learned now that it has identified its financial needs and financing requirements? It has learned:

- *to seek the advice of a financial advisor and legal counsel early in the process;*
- *that financial advisors are mainly coaches, and the New Tech management team will be doing most of the work;*
- *to use its own management team as much as possible in identifying its financial needs;*
- *that there may be government tax credits available;*
- *that there are numerous factors that may influence the amount of financing it needs; and, most important,*
- *that there is a significant range of financing available.*

Myths

All a potential investor needs to hear are the words "trust me."

Those are important words, but you must support them. Trust is something that is earned, not given. You have to build a relationship with investors, even before they invest in your business. You do this, partly, by presenting reasonable and credible forecasts. You must demonstrate that you understand and are comfortable with your forecasts. In addition, you must support these forecasts with realistic objectives and assumptions.

I will just get the money and worry about the rest later. (After all, what can investors do once I have their money in my hands?)

Each financing arrangement holds certain terms that can restrict you. If you do not abide by these constraints, there may be serious repercussions for the financial viability of your business. As well, a potential investor may want to take a very direct management role in your company. Ask yourself if you able to live with the constraints, obligations and requirements set out in the investment agreement, written or oral.

Equity is too expensive.

Companies that rely solely on debt financing to grow can end up in serious difficulties if their financial performance doesn't go according to plan. Equity participation does not generally require cash costs. These investors usually seek to make a return by selling their share of the company to the general public through an initial public offering.

Frequently Asked Questions (FAQs)

How much will it cost to hire someone to prepare financial statements?

It depends. The more work you do in advance, the less the cost will be. Consider other alternatives. For example, you may want to hire a business student to prepare the preliminary financial projections, then hire a professional financial advisor to review them. This would help to reduce the cost of preparing the investment proposal.

Do some preliminary forecasting. Satisfy yourself that the preliminary financial projections indicate a good potential for raising capital. If you do this, you will be more inclined to invest money to prepare a professional investment proposal.

An investment proposal may cost between $2,000 and $25,000.

Why does an investor need cash flow forecasts? Are my financial statements not enough?

Your financial statements indicate your past performance. This information will certainly be of interest to potential investors. However, they will look to your company's projected financial statements to determine whether your business is a good investment that will generate a return on their investment.

Why does an investor not simply want market appraisals on my capital assets?

Capital assets are only part of the equation. Value depends largely on the potential resale value of your assets. For businesses that are expected to continue to operate and grow, value is more directly related to the ability of your business to generate cash flow.

Exhibit 1.1
New Tech Distributors Corp.
Income Statements

($000s)	1998 Actual	1999 Forecast	2000 Forecast
Sales revenue	3,000	3,900	4,700
Cost of goods sold			
Purchases	610	710	800
Freight in	60	70	85
Labour	380	480	510
Depreciation and amortization	110	175	195
Utilities, insurance, etc.	25	30	35
Total cost of goods sold	1,185	1,465	1,625
Gross margin	1,815	2,435	3,075
Selling expenses			
Salaries	620	780	820
Commissions	60	80	110
Travelling	60	90	115
Advertising	70	100	105
Depreciation and amortization	30	50	70
Special promotional program	17	220	100
Total selling expenses	857	1,320	1,320
Administrative expenses			
Salaries	395	420	465
Leasing	50	70	90
Depreciation and amortization	60	100	110
Research & development	50	100	100
Total administrative expenses	555	690	765
Total operating costs	1,412	2,010	2,085
Operating income	403	425	990
Interest income	5	6	8
Interest charges	95	115	155
Extraordinary expenses	0	0	0
Income before taxes	313	316	843
Income taxes	109	111	295
Income after taxes	204	205	548

Exhibit 1.2
New Tech Distributors Corp.
Statements of Retained Earnings

($000s)	1998 Actual	1999 Forecast	2000 Forecast
Retained earnings (beginning of year)	500	654	839
Net earnings for the year	204	205	548
Subtotal	704	859	1,387
Dividends	50	20	110
Retained earnings (end of year)	654	839	1,277

Exhibit 1.3
New Tech Distributors Corp.
Balance Sheets

($000s)	1998 Actual	1999 Forecast	2000 Forecast
Assets			
Current assets			
Cash	20	30	45
Marketable securities	100	110	120
Prepaid expenses	60	70	80
Accounts receivable	450	550	650
Inventory	350	425	475
Other assets	70	103	120
Supplies, etc.	84	120	140
Total current assets	**1,134**	**1,408**	**1,630**
Capital assets			
Gross capital assets	1,775	2,875	3,615
Accumulated depreciation	560	885	1,260
Total net capital assets	**1,215**	**1,990**	**2,355**
Goodwill	45	45	45
Other assets	5	5	7
Total assets	**2,399**	**3,448**	**4,037**
Current liabilities			
Accounts payable	550	600	650
Term loan	125	140	170
Working capital loan	50	59	150
Accruals	60	50	80
Current portion of long-term debt	30	30	30
Total current liabilities	**815**	**879**	**1,080**
Total long-term debts	**400**	**600**	**550**
Total liabilities	**1,215**	**1,479**	**1,630**
Owners' equity			
Capital shares	530	1,130	1,130
Retained earnings	654	839	1,277
Total owners' equity	**1,184**	**1,969**	**2,407**
Total liabilities and owners' equity	**2,399**	**3,448**	**4,037**

Exhibit 1.4

New Tech Distributors Corp.
Cash Flow Forecasts

($000s)	**1999** Actual	**2000** Forecast
Operating activities		
Income after taxes	205	548
Depreciation and amortization	325	375
Working capital changes	-200	-6
Operating cash flows	330	917
Financing activities		
Capital shares	600	0
Long-term debts	200	-50
Dividends	-20	-110
Cash flow from financing acti	780	-160
Investing activities		
Capital asset additions	-1,100	-742
Cash bank balance	-10	-15,000
Net cash flow	0	0

Exhibit 1.5

New Tech Distributors Corp.
Statements of Changes in Financial Position

($000s)	1999 Forecast	Total	2000 Forecast	Total
Operating activities				
Income after taxes	205		548	
Depreciation and amortization	325		375	
Marketable securities	-10		-10	
Prepaid expenses	-10		-10	
Accounts receivable	-100		-100	
Inventory	-75		-50	
Other assets	-33		-17	
Supplies, etc.	-36		-20	
Accounts payable	50		50	
Term loan	15		30	
Working capital loan	9		91	
Accruals	-10		30	
Current portion of long-term debt	0		0	
Total operating activities		**330**		**917**
Financing activities				
Capital shares	600		0	
Total long-term debts	200		-50	
Dividends	-20		-110	
Total financing activities		**780**		**-160**
Investing activities				
Gross capital assets	-1,100		-740	
Goodwill	0		0	
Other assets	0		-2	
Adjustment	0		0	
Total investing activities		**-1,100**		**-742**
Increase (Decrease)	-10	**-10**	-15	**-15**
Cash -- Beginning of year	20		30	
Cash -- End of year	30		45	
Total • Net cash flow		**0**		**0**

Exhibit 1.6
New Tech Distributors Corp.
Financial Ratios

	1998 Actual	1999 Forecast	2000 Forecast
Liquidity Ratios			
Working capital ($000)	319	529	550
Current ratio (times)	1.39	1.60	1.51
Cash ratio (times)	0.15	0.16	0.15
Quick ratio (times)	0.96	1.12	1.07
Working capital turnover (times)	9.40	7.37	8.55
Leverage Ratios			
Debt to total assets (percent)	50.65%	42.89%	40.38%
Debt to equity (times)	1.03	0.75	0.68
Times interest earned (times)	4.29	3.75	6.44
Fixed charges coverage ratio (times)	3.16	2.71	4.44
Management Ratios			
Average collection period (days)	54.75	51.47	50.48
Accounts receivable turnover (times)	6.67	7.09	7.23
Inventory turnover (times)	3.39	3.45	3.42
Day's sales to inventory (days)	108	106	107
Fixed assets turnover (times)	2.47	1.96	2.00
Total assets turnover (times)	1.25	1.13	1.16
Profitability Ratios			
Gross margin to sales (percent)	60.50%	62.44%	65.43%
Operating income sales (percent)	13.43%	10.90%	21.06%
Income after taxes to sales (percent)	6.80%	5.26%	11.66%
Return on total assets (percent)	8.50%	5.95%	13.57%
Return on invested capital (percent)	12.88%	7.98%	18.53%
Return on equity (percent)	17.23%	10.41%	22.77%

Exhibit 1.7
New Tech Distributors Corp.
Key Assumptions (Base Case)

	1998 Actual	1999 Forecast	2000 Forecast
Sales revenue	$3,000,000	$3,900,000	$4,700,000
Annual sales growth (%)	15.0%	30.0%	20.5%
Sustainable growth (%)	14.95%	10.37%	22.24%
Financial health score (Z score)	2.93	2.86	3.47
Gross margin (% of sales)	61.0%	62.0%	65.0%
Selling expenses (% of sales)	29.0%	34.0%	28.0%
General and adm. expenses	$445,000	$490,000	$555,000
Research and development expenses	$50,000	$100,000	$100,000
Depreciation & amortization	$200,000	$325,000	$375,000
Income taxes and research development tax credits			
Income tax rate	35.0%	35.0%	35.0%
Research & development expenses	$50,000	$100,000	$100,000
Investment tax credit rate	35.0%	35.0%	35.0%
SR&D credit (cash refund)	$17,500	$35,000	$35,000
Net research and development expenses	$32,500	$65,000	$65,000
Balance sheet/working capital			
Average collection period (days)	54.75	51.47	50.48
Inventory turnover (times)	3.39	3.45	3.42
Average payment period (days)	30	28	27
Fixed assets addition	$200,000	$1,100,000	$740,000
Interest rates			
Working capital loan	7.0%	7.0%	7.0%
Excess cash and marketable securities	4.0%	4.0%	4.0%
Term loan	10.0%	10.0%	10.0%

Exhibit 1.8
New Tech Distributors Corp.
Sensitivity Analysis

	1998 Actual	1999 Forecast	2000 Forecast
Base case			
Sales revenue	$3,000,000	$3,900,000	$4,700,000
Gross margin	$1,815,000	$2,435,000	$3,075,000
Operating income	$403,000	$425,000	$990,000
Income after taxes	$204,000	$205,000	$548,000
Income after taxes to sales (%)	6.80%	5.26%	11.66%
Return on total assets (%)	8.50%	5.95%	13.57%
Economic value added	$71,000	-$28,000	$247,000
Sustainable growth rate	14.95%	10.37%	22.24%
Financial health score (Z-score)	2.93	2.86	3.47
Scenario A			
Sales revenue decrease by 5%			
Sales revenue	$3,000,000	$3,705,000	$4,465,000
Gross margin (%)	$1,815,000	$2,314,000	$2,896,000
Operating income	$403,000	$310,000	$831,000
Income after taxes	$204,000	$131,000	$445,000
Income after taxes to sales (%)	6.80%	3.53%	9.96%
Return on total assets (%)	8.50%	3.79%	11.03%
Economic value added	$71,000	-$93,000	$168,000
Sustainable growth rate	14.95%	6.07%	16.76%
Financial health score (Z-score)	2.93	2.63	3.15
Scenario B			
Sales revenue decrease by 10%			
Sales revenue	$3,000,000	$3,510,000	$4,230,000
Gross margin (%)	$1,815,000	$2,182,000	$2,731,000
Operating income	$403,000	$182,000	$671,000
Income after taxes	$204,000	$47,000	$341,000
Income after taxes to sales (%)	6.80%	1.34%	8.06%
Return on total assets (%)	8.50%	1.37%	8.44%
Economic value added	$71,000	-$166,000	$88,000
Sustainable growth rate	14.95%	1.45%	11.46%
Financial health score (Z-score)	2.93	2.39	2.83

Exhibit 1.9
New Tech Distributors Corp.
Break-even Analysis

($)	1998 Actual	1999 Forecast	2000 Forecast
Sales revenue	3,000,000	3,900,000	4,700,000
Variable costs			
Purchases	610,000	710,000	800,000
Freight in	60,000	70,000	85,000
Labour (cost of goods sold)	300,000	390,000	410,000
Commissions	60,000	80,000	110,000
Total variable costs	1,030,000	1,250,000	1,405,000
Contribution margin	1,970,000	2,650,000	3,295,000
Fixed costs			
Labour (cost of goods sold)	80,000	90,000	100,000
Depreciation and amortization	200,000	325,000	375,000
Utilities, insurance, etc.	25,000	30,000	35,000
Salaries (selling)	620,000	780,000	820,000
Travelling	60,000	90,000	115,000
Advertising	70,000	100,000	105,000
Other charges (selling)	17,000	220,000	100,000
Salaries (administration)	395,000	420,000	465,000
Leasing	50,000	70,000	90,000
Research and development	50,000	100,000	100,000
Interest charges (net)	90,000	109,000	147,000
Total fixed costs	1,657,000	2,334,000	2,452,000
Profit (loss)	313,000	316,000	843,000
Profit/volume ratio	0.66	0.68	0.70
Break-even point (in revenue)	2,523,350	3,434,943	3,497,542
% of sales revenue	84.1%	88.1%	74.4%

Assets	$2,399,000	$3,448,000	$4,037,000
Before taxes			
Income before taxes	$313,000	$316,000	$843,000
Return on total assets	13.0%	9.2%	20.9%
After taxes			
Income after taxes	$204,000	$205,000	$548,000
Return on total assets	8.5%	6.0%	13.6%
Before tax objective			
To earn a return on assets of . . .		15.0%	25.0%
your income before taxes should be . . .		$517,000	$1,009,000
and your sales revenue should be . . .		$4,195,811	$4,936,783

Exhibit 1.10
New Tech Distributors Corp.
Cash Budget — 1999

	Oct.	Nov.	Dec.
Sales revenue (previous year)	325.0	325.0	325.0
Purchases			59.2
Payment schedule			
Cash sales = 10%	10%		
30-day payment = 70%	70%		
60-day payment = 20%	20%		
Purchase schedule			
Paid in first month = 40%	40%		
Paid during second 60 days = 60%	60%		

	Jan.	Feb.	March	April	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Total
Sales revenue	325	300	275	325	350	375	400	375	350	300	275	250	3, 900
Cash sales	33	30	28	33	35	38	40	38	35	30	28	25	390
30-payment = 70%	228	228	210	193	228	245	263	280	263	245	210	193	2, 782.5
60-day payment = 20%	65	65	65	60	55	65	70	75	80	75	70	60	805
Total monthly receipts	325	323	303	285	318	348	373	393	378	350	308	278	
Purchases	59.0	59.2	59.2	59.2	59.2	59.2	59.2	59.2	59.2	59.2	59.2	59.2	710
Paid during first month = 40%	24	24	24	24	24	24	24	24	24	24	24	24	284
Paid during second 60 days = 60%	36	35	36	36	36	36	36	36	36	36	36	36	426
Total monthly purchases	50.0	45.0	50.0	55.0	80.0	75.0	72.0	60.0	58.0	55.0	50.0	60.0	710
Total receipts	**325**	**323**	**303**	**285**	**318**	**348**	**373**	**393**	**378**	**350**	**308**	**278**	**3, 977.5**
Disbursements													
Purchases	50	45	50	55	80	75	72	60	58	55	50	60	710
Freight in	4.2	4.0	5.1	5.4	7.3	6.5	6.7	6.6	6.1	7.0	5.8	5.7	70
Labour	40.0	39.0	38.0	42.0	38.4	44.3	42.5	41.0	38.0	39.0	39.5	38.0	480
Utilities, insurance, etc.	2.5	2.2	2.4	2.5	2.5	2.8	2.7	2.5	2.6	2.6	2.6	2.4	30
Salaries — selling	60.0	62.0	65.8	62.8	62.7	67.9	71.6	62.8	64.9	66.9	68.0	65.0	780
Commissions	5.9	5.0	5.8	6.8	6.9	7.4	8.0	7.8	6.5	6.8	6.4	6.4	80
Travelling	7.0	7.1	6.9	6.8	7.6	7.8	8.4	7.5	7.7	7.7	7.9	7.4	90
Advertising	6.0	6.5	7.0	9.0	8.5	8.7	8.3	8.1	7.0	7.2	6.0	7.5	90
Other charges — Selling	5.0	6.0	3.0	40.0	50.0	21.5	18.3	18.7	18.9	16.0	8.5	14.0	220
Salaries — administration	35.0	35.0	34.0	33.0	36.0	36.0	38.0	39.0	35.0	33.0	32.0	34.0	420
Leasing	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8	70
Research and development	8.3	10.3	15.6	7.5	8.3	7.7	7.9	6.2	6.7	6.9	6.3	8.3	100
Interest income	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-6
Interest charges	9.4	9.6	9.7	9.5	9.6	9.8	9.8	9.5	9.6	9.8	9.5	9.5	115
Taxes	9.3	9.3	9.3	9.3	9.3	9.3	9.3	9.3	9.3	9.3	9.3	9.3	112
Purchase of assets	40.0	45.0	33.0	350.0	###	16.8	23.8	23.0	18.0	20.0	20.0	10.0	1, 099.6
Total disbursements	**288**	**291**	**291**	**645**	**832**	**327**	**333**	**307**	**294**	**293**	**277**	**283**	**4, 460.5**
Surplus (-) /month	37	31	12	-360	-515	20	40	85	84	58	30	-5	
Surplus(-) /cumulative	37	68	80	-280	-795	-775	-735	-650	-566	-508	-478	-483	
Beginning bank balance	20	57	88	100	-260	-775	-755	-715	-630	-546	-488	-458	
Receipts	325	323	303	285	318	348	373	393	378	350	308	278	
Disbursements	288	291	291	645	832	327	333	307	294	293	277	283	
Ending bank balance	57	88	100	-260	-775	-755	-715	-630	-546	-488	-458	-463	
Long-term financing													
Debt	10.0	20.0	20.0	60.0	50.0	8.0	20.0	6.0	4.0	2.0	0.0	0.0	200
Equity	10.0	20.0	50.0	200.0	###	44.4	10.0	5.0	5.0	4.0	2.0	0.0	600
Total	20.0	40.0	70.0	260.0	###	52.4	30.0	11.0	9.0	6.0	2.0	0.0	800
Cash flow after financing													
Monthly	57	71	82	-100	-215	73	70	96	93	64	32	-5	
Cumulative	37	108	190	90	-125	-52	18	114	207	270	303	297	

Exhibit 1.11
New Tech Distributors Corp.
Financial Needs and Financing Requirements

($)	Uses *Financial Needs*	Sources *Financing Requirements*
Short-term needs/requirements		
Working capital accounts		
Accounts receivable	100,000	
Inventory	75,000	
Accounts payable		50,000
Other working capital accounts		
Marketable securities	10,000	
Prepaid expenses	10,000	
Other assets	33,000	
Supplies, etc.	36,000	
Accruals	10,000	
Conventional financing		
Term loan		15,000
Working capital loan		9,000
Total short-term financing Needs/requirements	**274,000**	**74,000**
Long-term needs/requirements		
Capital assets (needs)	1,100,000	
External sources		
Dividends	20,000	
Equity		600,000
Long-term debt		200,000
Total long-term needs/requirements	**1,120,000**	**800,000**
Internal sources		
Increase in the cash account	10,000	
Income after taxes		205,000
Depreciation and amortization		325,000
Total internal sources	**10,000**	**530,000**
Total needs/requirements	**1,404,000**	**1,404,000**
Marketing costs and cushion	**171,000**	**171,000** *
	1,575,000	**1,575,000**

* The $275,000 before-tax marketing costs and cushion will be financed by internally generated funds and has been included as expenses in the 1997 income statement. On an after-tax basis, these costs amount to $171,000.

Module 2: Demonstrate Your Investment Potential

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Executive Summary

This module demonstrates how to examine your investment opportunity to measure its viability and potential to suit investor needs. Before investing in your project, risk capital investors will want to know if their investment will generate a return that will compensate for their risk. This module presents the more common valuation techniques.

> If you do not have a good understanding of some of the financial concepts presented in this module, such as time value of money, you might consider working on it one section at a time. You may also want to discuss this material with an advisor or the person responsible for financial management within your company.

Risk capital investors want to help entrepreneurs launch their idea or expand their operations; however, they expect a high financial payback or return on their investment. These investors run the gamut from public investors to private businesspeople such as doctors and lawyers, often considered "angels" to institutional investors. Each type of investor has her/his own characteristics and peculiarities with regards to risks and returns, and you should be sensitive to this if you are to respond effectively to investor needs.

To convince investors of your business intentions, you have to demonstrate that your investment opportunity can generate an exceptional return and that your management team is experienced and possesses complementary business skills (i.e. finance, production, marketing). The reputation and the quality of your management team are the issues, and investors will have to be convinced that they can steer your investment idea to its fullest potential. This module looks at the investment opportunity while the next module, Demonstrate Your Management Capabilities, deals with the management team.

Seasoned risk capital investors are much like horse race betters in seeking out winners. They realize that to obtain an excellent return on their investment, they need two things: a good horse (product or service) and a skilled jockey (management team). To be sure, a horse with a proven record will attract many betters, and a jockey with a winning record will undoubtedly multiply their chances. The significance of these two points is covered in both this module and the next.

To pinpoint the merits of a business opportunity, business owners have to understand investors' financial needs if they are to attract their interest. Risk capital lenders look for ideas that will generate a high return to compensate for the risks, and to generate a significant amount of cash when they make their exit from the company; this is when they will want to cash in on their investment.

> If investors are not convinced about the potential of your investment opportunity and their ability to capitalize on it, you will not be able to raise the risk capital funds you need to launch your project.

The New Tech Distributors Corp. case example shows how a monetary value can be demonstrated for an ongoing business. If you have read New Tech's case in the Steps to Growth Capital Overview and in

Module 1, Identify Your Financial Needs, you are familiar with the company's background, financial statements, financial needs and financing requirements.

This module covers five topics.

1. **What does an investor look for in a business opportunity?** How can you demonstrate that your investment opportunity clearly meets the needs and expectations of risk capital investors?

2. **How should you demonstrate your potential for growth?** What type of information should be included in an investment proposal to show that your investment opportunity meets investor needs? If the opportunity cannot be clearly demonstrated, investors will not be interested in your project.

3. **How can you measure your potential for profit?** What financial concept is used to calculate the potential value of your business? How can you determine the return on investment demanded by risk capital investors?

4. **How do you measure the value of your business?** What specific techniques are used by investors to determine the value of your business? What critical elements and steps are used by risk capital investors to determine the after-tax return they will be looking for at the time of exit? The potential market value (not collateral or security) of your business will determine, to a large extent, investors' expected rate of return and cash payback.

5. **How do you decide on the exit strategy?** What exit strategies and options are available to risk capital investors? What financial information plays a key role in determining the choice of the exit strategy?

Details

Throughout this module, we will refer to the case example, New Tech Distributors Corp., to show how investment potential can be demonstrated. Background information and the challenges that New Tech faces were presented in the introductory Steps to Growth Capital Overview. More detailed information about the company is presented in exhibits 2.1 to 2.7(b).

1. What an Investor Looks for in a Business Opportunity

When approaching risk capital investors, you must be vigilant about how they think, what motivates them and how they gauge risk. When deciding to invest money in a business venture, these investors will ask many questions about its viability and profitability. You should be prepared to respond to the following sample questions potential investors are asking themselves:

- What are the characteristics of this company? This industry? What are the industry realities and practices? Is this the kind of industry I want to invest in?
- Does this company match my vision and interest as an investor? Is it too big? Is it located too far away?
- What evidence is there of customer acceptance for the product or service? Has the product or service been tried or used? Is it being tested on a trial basis?
- Does the entrepreneur understand my needs?
- What are the terms of this deal or investment (i.e. percentage of the company being sold, the minimum investment, number of investors, total market value of the business)?
- What are the historical financial structure (balance sheet) and financial performance (income statement) of this business? What is the projected financial profile of the business?
- What is the calibre of the people managing this business? Are they focussed?
- Does the business possess exclusive rights to the product or process (i.e. patents, copyright or trademark protection)?

The negotiations process between a business owner and a risk capital investor is lengthy and exhaustive. If a risk capital investor is interested in your business venture, before signing the deal, he or she will want to have four conditions included in the final agreement.

An acceptable rate of return. Investors want to see some evidence that the investment opportunity will generate a return commensurate with the risk — usually 25% to 40% compounded and adjusted for inflation. Techniques for measuring return on investment and payback are covered in this module.

Confidence in management. Most risk capital investors claim that management is the single most important aspect of a business opportunity. The reputation and quality of the team are key. Does the management team possess the collective business skills needed to carry the project through to a successful conclusion? Investors will also scrutinize the founders, board of directors, current investors and outside professionals (accountants, lawyers, bankers, consultants, directors) in the hope of uncovering a familiar name. This will be covered in the next module, Demonstrate Your Management Capabilities.

A viable exit strategy and options to realize their investment. Since investors usually want to cash in their shares somewhere between three and seven years after making their investment, they want to be assured that the business owners have thought about how to comply with their wishes. Will the company go public? Will it be sold? How? Will current business owners buy out the investors? This has to do with the exit strategy which often is the only way that risk capital investors are able to secure a 25% to 40% return on their investment. Options include an initial public offering, the sale of all of the shares of the company, the sale of the investor's shares to a third party, buyback of the investor's shares by the company and debt repayment.

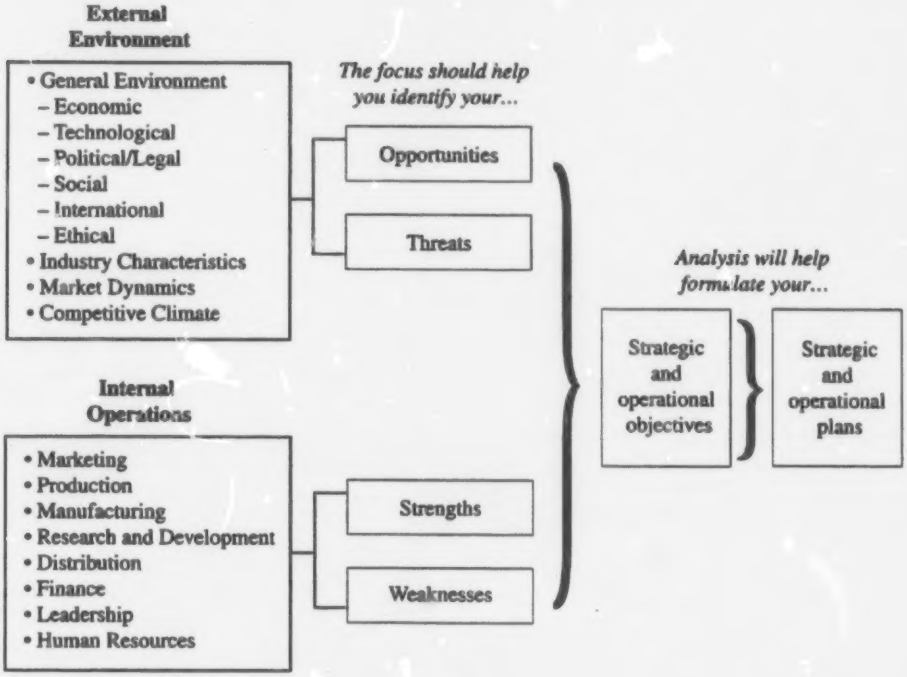
Ability to monitor and control the investment. Risk capital investors are not usually interested in gaining control over the business they are investing in, nor taking an active role in managing it on a day-to-day basis. However, they want to protect their investment and will ensure that control mechanisms are in place to help monitor the business. This can be achieved by:

- having a voice on the board of directors;
- suggesting who should sit on the board (its composition);
- receiving monthly financial statements;
- approving additional financing or capital expenditures that are over certain amounts and the payment of dividends; and
- having a say in hiring key managers and even securing contractual employment agreements with key executives.

2. How to Demonstrate Your Potential for Growth

The key to demonstrating the potential growth and profitability of your business opportunity is to make a diagnostic or situation analysis of the industry you operate in (opportunities and threats) and develop a profile of your business (strengths and weaknesses). A situation analysis helps to determine the features of your company's internal and external environments that will most directly affect your strategic decisions and plans. Will your investment opportunity have the potential to flourish in the market it will operate in? Will the business itself be able to make it happen? As shown in Figure 2.1, a situation analysis covers two main elements: the external environment (industry, competitors, etc.) and the internal operations (marketing, production, etc.) of your business. This analysis can help convince risk capital investors that a new venture will have a "good fit" in its environment and competitive arena. In addition, this evaluation helps business owners formulate their strategic objectives and plans to show how the investment opportunity will realize its maximum potential.

Figure 2.1
The Situation Analysis


External Environment
• General Environment
– Economic
– Technological
– Political/Legal
– Social
– International
– Ethical
• Industry Characteristics
• Market Dynamics
• Competitive Climate
The focus should help you identify your...
Opportunities
Threats
Internal Operations
• Marketing
• Production
• Manufacturing
• Research and Development
• Distribution
• Finance
• Leadership
• Human Resources
Strengths
Weaknesses
Analysis will help formulate your...
Strategic and operational objectives
Strategic and operational plans

Before launching an investment opportunity, the first step in the decision-making process is to analyse the external and internal factors of your business, commonly referred to as the SWOT analysis. SWOT is an acronym for identifying a firm's strengths, weaknesses, opportunities and threats. Strengths and weaknesses deal with a company's internal operations; opportunities and threats focus on a company's external environment.

This analysis ensures that the strategic objectives and plans related to launching your new business venture will have intended results. Formulating your company's strategic objectives and plans is not done in a vacuum. Since your business continually interacts with its external environment, this analysis will help you harmonize your business (products and services) with its external environment (customers, suppliers, government regulations, competitors, etc.).

Analysis of the External Environment

Risk capital investors analyse the external environment of the business in which they will invest for two reasons. First, the external forces will determine, to a large extent, the degree of success of the business venture. Second, investors want to make sure they will be "making the right decisions" about the venture. They will ask themselves: What is the likelihood for this product or service to succeed in this environment?

Analysing the external environment of your business focusses on its opportunities and threats. *Opportunities* are elements of your external environment that offer avenues for growth and profitability.

Threats, on the other hand, are those elements of your external environment that may be obstacles to the well-being of your business.

Investors want to examine your company's external environment to make sure you are aware of the universe in which it interacts. They want answers to two broad questions: How will you exploit your opportunities? How will you overcome the threats that can, if they are not dealt with effectively, paralyse your business?

As shown in Figure 2.1, the analysis of the external environment can be done at four levels: general environment, industry characteristics, market dynamics and competitive climate. The information that should be analysed and the questions that follow under these four headings are by no means exhaustive. They only represent the "type" of information and data you should be prepared to investigate in order to respond effectively to the concerns that may be raised by potential risk capital investors.

General environment

The general environment deals with the more remote elements that can affect the well-being of your business. These include the economic, technological, political/legal, social, international and ethical environments. Typical issues that you will have to explore include:

- growth rate of the gross national product;
- rate of inflation;
- level of capital investments;
- state of financial markets (cost of capital); and
- exchange rates (strength of the Canadian dollar).

Much of this information can be obtained from economic forecasts provided by chartered banks and the Conference Board of Canada, and from forecasts and economic assumptions contained in federal and provincial/territorial government annual budgets.

Industry characteristics

Risk capital investors want to be knowledgeable about the industry in which your company operates. They want to understand industry dynamics that affect the valuation and overall assessment of your business, its macro-environment and elements such as the economies of scale, pace of technological change, level of capital investments, degree of business risk, importance of product innovation and life cycle, prevalence of backward and forward integration, and the overall growth rate and profitability. The analysis of the industry characteristics should expand on the following:

- Is a large volume of production required to be cost competitive in this industry (economies of scale)? What is the optimal cost structure or operating leverage (fixed versus variable costs)?
- Will surpluses push prices and profit margins down? Will shortages pull them up? What is the relationship between supply and demand?
- Is this industry profitable? Is it growing? How fast? If it is growing, will it pull in new entrants? How many? What will be the impact on the industry?
- Does this industry require big investments? What are the barriers to new entrants?
- To what extent is the industry regulated? What impact does this have on industry growth and profitability?
- Is this industry competing against other industries (substitute products)? What are they? Are they real threats? How do consumers regard these substitute products?

Information from industry surveys and reports prepared by independent parties (business associations, government studies, etc.) should be included in the investment proposal. This will make your analysis more convincing and will validate your information about the industry. This material can be obtained from the following sources:

- corporate and industry association Web sites;
- corporate annual reports;
- specific industry surveys and studies;
- industry association information; and
- research reports prepared by brokerage firms.

Market dynamics

Market dynamics describe the factors affecting your company's ability to sell products or services at a profit. Critical components of market analysis include the market segmentation of your customer base (purchasing habits and preferences); product features and benefits; price sensitivity; number, size and market strategies of the more important leaders including size of their market share; and the nature of the competitive environment (hostile or passive, direct or indirect). Typical questions that investors will want to focus on about market dynamics include the following:

- Can you define the markets in which your company competes?
- What are these different markets and their sizes?
- How will you attract and keep this market?
- What percent of the market will you have?
- What is the market's growth potential?

If you understand the market in which your business competes and the likely future of your market, you will better acknowledge what is driving the growth potential of your business. The capacity for sustained growth in a particular market is important in a risk capital investor's overall investment decision.

Competitive climate

Risk capital investors will also want to learn about your competitive advantage over others. Just knowing the current competitive position of your company is not enough. They will want to know about your staying power and your ability to outperform and even acquire competitors. This information is important for investors when making an investment decision.

- Are competitors numerous? Are they roughly equal in size and power?
- Why do your customers buy from you and not from your competitors?
- Can you make a list of your key competitors in each market you compete in?
- Can you demonstrate how your company differentiates itself from your competitors? What are your key areas of competitive advantage?
- Is your price competitive? How did you arrive at your price structure?
- Are new competitors entering the market? Who are they? Where are they from?
- How do you get your products and services to your end users?
- How will your operations be better than theirs?

Analysis of the Internal Operations

Risk capital investors will want to know more than just the elements of the external environment that might affect the growth and prosperity of your business. They will also want to scrutinize specific details about your business in order to measure its true potential. Analysing your internal operations helps investors identify your company's strengths and weaknesses. A *strength* is something your company is good at or that gives you an advantage or edge over competing firms. A *weakness* could be described as something your company does poorly that puts your business at a competitive disadvantage. This diagnostic process should help you capitalize on your strengths and find solutions to overcome your weaknesses.

This analysis helps you understand more fully your company's ability to grow, to be profitable and to remain economically viable. It also helps you focus on your strategic objectives and plans in terms of what is required to capitalize on your investment. You will have to decide which operating functions need to be exploited further and which ones need to be reinforced (for example, marketing, production, manufacturing, research and development, distribution, finance, leadership and human resources).

Analysing your internal operations over a multi-year period (for example, the past two to five years) and comparing them to your more successful competitors (using a benchmarking approach) can help you draw a much better business profile of your strengths and weaknesses. Benchmarking for the more important operating functions is covered in Module 3, Demonstrate Your Management Capabilities. The following questions, although not exhaustive, illustrate some key issues you should focus on when analysing your company's strengths and weaknesses. Comprehensive answers to these questions will certainly be of interest to your risk capital investors.

About management

- What is the profile of your key executives? What is their leadership style?
- What is your management philosophy? What is the CEO's vision about the business?
- What are your management's technical and professional skills? Are they complementary?
- What are your salaries and remuneration (i.e. bonus, commissions, stock options)?

About marketing

- What is the profile of your customers? How many do you have?
- What is your product's position in the marketplace?
- What is your pricing strategy?
- What are your promotional strategies?
- How effective is your sales force?

About manufacturing

- What is your plant capacity? What is your existing output?
- What is the state of your manufacturing technology?
- What is your break-even point? What is your profit break-even?
- What is your cost of raw materials? Who are your suppliers?
- Did you obtain your ISO 9000 certification? Are you in the process of getting it?

About finance

- What are the trends of the company's financial structure (balance sheets) and financial performance (income statements)?
- Who are the company's external financial auditors?
- What are your accounting principles regarding depreciation, research and development (R&D), taxes, inventories, etc.?
- What is your cash flow position? How much cash is generated internally? Externally?
- What is the financial health of your business? What is your sustainable growth rate?

About human resources

- Can you give a description of the quality of your employees? What is their experience and education?
- What is the employee turnover rate?
- How are your employees evaluated? How are they remunerated?
- How much money do you invest in training on a per employee basis?
- Do your employees work in teams? How effective are your teams?
- What is your employee benefit package? What are the costs as a percentage of salaries?
- What are the general conditions of your union agreements and issues?

About distribution

- How does your product reach your end users?
- What is the nature of your company's distribution network (i.e. wholesalers, retailers)?
- What is the composition of your company's sales distribution network?
- How much does it cost to distribute your products or services?
- How many warehouses do you have? Where are they located? What is their size?

About research and development

- Do your company's R&D objectives and programs have strategic significance?
- What is your current budget for research?
- What percentage of your operating income or sales revenue is allocated to your R&D effort?
- How many employees work in your R&D department? What are their qualifications?
- What percentage of your current sales is generated by past R&D?
- Is your company affiliated with independent and government laboratories, research institutions, consultants, captive suppliers of equipment?

A Plan to Capitalize on Market Opportunity

As shown in Figure 2.1 on page 5, the assessment of your company's external environment and internal operations establishes a framework to help you develop informed strategic objectives and plans. An objective is a measurable statement with a time frame for its accomplishment. These objectives should be backed by strategies and operational plans. (These form the basis of your business and investment plans.) Risk capital investors want to see your objectives and your plans because they want to gauge *where* your business is going and *how* it is going to get there. Your objectives, strategies and plans should be formulated for each operating function (i.e. marketing, production, research and development, finance, human resources, etc.).

Your objectives, strategies and detailed plans should demonstrate the specific steps you will follow to capitalize on your business opportunity. There are a number of considerations you should include in the description of your plans:

- expected timing of activities and resources required to implement your plan in terms of people, investments in additional assets and financing;
- specific actions to minimize identified threats to your company;
- specific actions to help you take advantage of an opportunity;
- specific actions to help you capitalize on your company's strengths; and
- specific plans to minimize or eliminate your company's weaknesses.

3. How to Measure Your Potential for Profit

This section deals with the measurement tool used to quantify the viability and profitability of your investment opportunity. Essentially, quantitative information refers to the numbers that will substantiate your analysis. This information helps investors assess more precisely the potential return on their investment and provides insight about the size of the investment that will be required. It also serves as the basis for determining how much your business will be worth. This is discussed later in this module.

Quantitative information should summarize your company's current operating and financial position and its prospective results. Financial projections should always be backed up by supportable assumptions. This was the essence of the information contained in the preceding text.

Both the qualitative assumptions and quantitative information will be the foundation for determining the company's future financial performance in terms of profitability and cash flow, and for pinpointing the future value of the shares of the business.

The company's historical operating and financial performance should be examined and submitted to your investors. Assessing where your company has been will help investors better understand what it is capable of achieving.

> If you are familiar with the concept of time value of money and investment analysis tools, such as the internal rate of return and net present value, you may want to skip this section.

The Concept of Present Value and Required Rate of Return

This section deals with a common principle of business valuation: *time value of money*. This concept is important to investors because it helps put meaning to an important question: If I invest money in this business today, what return (%) will I earn on my investment? We all know that if we invest money in Canada Savings Bonds, we will earn around 5% each year. Similarly, if risk capital investors invest money in a business venture, they will want some idea of how much their investment will earn over the years: 20%? 30%? or 40%?

Risk capital investors invest *cash* (initial outflow) in a venture in return for *cash* (receipts such as interest, repayment of principal or proceeds received through equity participation). Assuming that an investment of $100,000 generates $20,000 each year over the next five years, investors would earn a 20% ($20,000 / $100,000) return on their investment each year. This is using the accounting rate of return method or the undiscounted approach. Investors do not use this method to gauge returns. Instead, they use *time value* yardsticks such as net present value (NPV) and internal rate of return (IRR) to determine the *true value* of their investment.

In most instances, risk capital investors are not paid on a yearly basis (such as interest paid to bankers); they usually wait, say five years (at exit time) for their payment. For example, instead of receiving $20,000 each year, they will wait until the business in which they have invested money, in the form of equity, is sold. At this point, they get paid and earn their return. If they receive $200,000 five years after their initial $100,000 investment, some may think that the investors will have doubled their investment or made a 100% return, but this calculation is misleading. By taking into account the fact that money has a *time value*, investors would earn only 15%. The following paragraphs explain how time value yardsticks are calculated and why it is important to use the time value of money concept to calculate return on investment for risk capital investors.

The cost (interest) associated with borrowing money (whether provided by shareholders or lenders), confirms the fact that money has a time value. There is an old saying reminding us not to count our cash before it is discounted. For example, if you have a choice between receiving $100 today or $105 a year from now, which one would be the preferred option? If banks charge 5% in interest, it does not matter. You could invest the $100 amount in a term deposit which would give you 5% interest. This would increase your initial investment to $105 one year from now ($100 X 1.050) with 1.050 being the compound value interest factor for one year at 5% from the future value table. Conversely, we can say that the $105 you would receive one year from now is equal to today's $100 ($105 X 0.95238) with 0.95238 being the present value interest factor for one year at 5% from the present value table.

These interest factors can be obtained from the interest tables available at the end of most finance books. There are four types of compound interest tables: the future value of a single sum, the present value of a single sum, the future value of an annuity and the present value of an annuity.

Just like bankers, risk capital investors account for the time value of money. However, there is one difference: They take a much greater risk and will demand a higher return on their investment. Let's examine the $100,000 example and assess how risk capital investors would look at this investment. If they invest $100,000 in the bank for a five-year period and earn 10% compounded each year, in five years, the investors would receive $161,000 ($100,000 X 1.610) with 1.610 being the compound value interest factor for five years at 10% from the future value table. Time is the only element that provides the investor with a $61,000 ($161,000 - $100,000) return, or 10% each year.

However, because investors invest money today in return for future cash receipts (interest or proceeds from the sale of a business), the proceeds that will be earned in future years must be discounted (because of the time value of money factor) to today's value. This makes it possible to compare the initial investment to the proceeds to be received in the future on an equal footing. Remember the old saying, a dollar earned tomorrow is worth less today!

Discounted Cash Flow Analysis

From the point of view of a risk capital investor, the discounted cash flow concept works like this: Show me the future cash flow of your business and let me apply a discount factor based on the rate of return I want to make. For example, if an investor invests $100,000 in equity into a high risk business venture for five years and demands a 30% return, using the time value yardstick approach, he or she would expect the future value of the initial investment to be worth at least $371,300 five years from now ($100,000 X 3.713) with 3.713 being the compound value interest factor for five years at 30% from the future value table. The investor would simply say: If I invest $100,000, I will require 30% which would be equivalent to $371,300 in proceeds received at the time of the buyout or exit.

Here is how the calculation is made.

Initial investment	- $100,000 (cash outflow)
Cash proceeds at time of initial public offering ($371,300 X 0.26933)	+ $100,000 (present value of the future receipt)
NPV	**0**

In this particular case, the risk capital investor would earn a 30% return on the investment which is also referred to as the IRR. The IRR can be defined as follows.

> *It is the interest rate (in this case 30%) that makes the cash outflow (initial investment of $100,000) equal (NPV or 0) to the present value (PV of $100,000) of the expected cash receipts ($371,300 in proceeds to be received five years from now).*

Specifically, the IRR or discounted cash flow (DCF) approach takes into account the amount, timing and degree of risk associated with the level of after-tax cash flow expected to be generated by your company.

Section 4 of this module discusses the methodology used for calculating the return on investment by using the DCF approach. For an illustration of the discounted cash flow approach, refer to New Tech Distributors Corp. exhibits 2.4 to 2.7.

Preparing Your Business for Investment

While preparing your company's financial projections, it is important to do a little housekeeping to maximize the value of your business. Actions that may increase the value of your business include:

- increasing the depth of management capabilities;
- improving the information systems (better information will reduce investor uncertainty);
- avoiding personal, non-market value transactions through your company (e.g. salaries in excess of market value);
- withdrawing redundant assets such as excess cash, stock portfolios and other assets not required in operations; and
- documenting verbal arrangements and agreements.

Nature of Return on Investment

Information provided to investors helps them determine the rate of return they can earn on their investment. The following two illustrations show how investors may calculate the return on their investment.

Example: Subordinated Debt Instrument

Using a subordinated debt instrument, investors will receive interest payments each year over a five-year period at a specified rate (in this case, 10%), the repayment of the principal and equity participation (often referred to as an "equity kicker") on exit. The following example summarizes the return to a subordinated debt investor.

	Years					
	0	1	2	3	4	5
In dollars						
Investment	(1,000)					
Interest received		100	100	100	100	100
Repayment of principal						1,000
Equity kicker[1]						600
Net cash	**(1,000)**	**100**	**100**	**100**	**100**	**1,700**

Rate of Return 18.33%[2]

Net Present Value

By using an 18% discount rate (expected return or IRR), the NPV gives a positive $12,000 and can be calculated as follows.

	Factors[3]			
Year 0 (cash outflow)				- $1,000
Year 1 (cash inflow: interest)	$100	x	.84746	$ 85
Year 2 (cash inflow: interest)	$100	x	.71818	$ 72
Year 3 (cash inflow: interest)	$100	x	.60863	$ 61
Year 4 (cash inflow: interest)	$100	x	.51579	$ 51
Year 5 (cash inflow: interest)	$100	x	.43711	$ 44
Year 5 (cash inflow: debt repayment)	$1,000	x	.43711	$437
Year 5 (cash inflow: equity kicker)	$600	x	.43711	$262
Total cash inflows				+ $1,012
NPV				+ $ 12

This means that the investor earns 18% plus $12,000. This $12,000 amount is equivalent to 0.33%. By using 18.33% factor, the NPV would be at 0.

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[1] Based on negotiated terms. This example assumes an equity kicker equal to 10% of the exit value, assumed to be $6,000.

[2] The 18.33% return (or IRR) can be determined by using a financial calculator.

[3] These factors are drawn from interest tables in the back section of most finance books.

Example: Equity Investment

Equity investors usually receive their return based on the exit mechanism. The following example summarizes the return to an equity investor.

	Years					
	0	1	2	3	4	5
In dollars						
Investment	(1,000)					
Interest received	0	0	0	0	0	0
Share of exit value[4]						4,000
Net cash flow	**(1,000)**	**0**	**0**	**0**	**0**	**4,000**

Rate of Return 31.95%[5]

If a 31.95% discount rate had been used, the NPV would have been 0.

4. How to Measure the Value of Your Business

Valuation is an important component of the investment analytical process. The initial valuation of your company at the time of the investment will provide the basis for the amount of ownership interest you will have to give up to secure risk capital. The amount of the investment made by an investor and the percentage of ownership received in return for that infusion of risk capital will ultimately be determined by the negotiations between you and the investor.

As mentioned earlier, from an investor's perspective, value is related to future cash flow. An investor will assess the information on your business to gauge its impact on future cash flow. In preparing to meet investors, you have to think in terms of what your company may be worth in the future, and cash is the deciding factor.

At this point in the investment process, you should have:

- determined your financing requirements;
- determined your growth potential and strategy; and
- projected future cash flow based on a set of reasonable and supportable assumptions reflecting the realization of the opportunity.

The next step is to demonstrate the value of your company's shares. As mentioned earlier, before you approach potential investors, existing shareholders should have an idea of the value of the shares of your company. They will have to agree on a range of value for the shares in order to negotiate the terms of the

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[4] Based on negotiated terms. This example assumes the equity investor would receive 50% of your company's shares, on exit, assumed to be $8,000.

[5] By using a 32% discount rate, the NPV is calculated as follows (with 0.24953 being the present value interest factor for five years at 32% from the present value table):

Year 0 (cash outflow)		- $ 1,000
Year 5 (cash inflow)	$4,000 × 0.24953	+$ 998 (PV)
Net cash flow		**- $ 2**

F2

agreement with new investors. In many cases, it will be important to demonstrate the reasonableness of your range of value (especially during the negotiation process).

This section presents some approaches to valuation and shows how to calculate the value of a business (in this case, New Tech Distributors Corp.) by using different valuation techniques:

- the book value;
- the liquidation value;
- the going concern value; and
- the discounted cash flow (DCF) value.

The first three methods are presented here because they can be used as benchmarks for determining the value of a business. However, the most accurate and effective way to determine a company's value in terms of return on investment is the DCF approach.

Book Value

Book value is what is shown on the books as net worth, or *shareholders' equity* based on generally accepted accounting principles. Book value can be described as the historical value of an asset which, at given time (the day it was purchased), represented the economic or market value of the asset, less its accumulated depreciation. It is determined by subtracting the liabilities from the book value of the assets. The difference gives you your net worth or shareholders' equity.

In practice, book value is seldom used, although it is widely believed that it is a realistic approach to measuring a small company's net worth. Exhibit 2.1 shows New Tech's book value for 1998. This information is drawn from Exhibit 1.1 presented in Module 1, Identify Your Financial Needs. As shown, New Tech's total liabilities, which amount to $1,215,000, are deducted from its total assets, amounting to $2,399,000. In this particular instance, its book value is $1,184,000.

Liquidation Value

A liquidation value is assigned to a business being sold in order to satisfy its creditors. Tangible assets, such as land, usually have a liquidation value close to their market value. Inventories and accounts receivable, on the other hand, are usually valued at less than what is shown in the books. To determine the liquidation value, all assets are assigned distressed values, and all debts are totalled at book value. Most assets sold under duress are discounted from their fair market value. The difference between the distressed value of the assets and the actual or book value of the liabilities is referred to as the *liquidation value*.

The liquidation value does not reflect the real worth of an asset or a business; in most cases, it is substantially below the market and book values. This method is used only if a company is in serious financial trouble. Exhibit 2.2 shows New Tech's liquidation value for 1998. This information was previously presented in Exhibit 1.3 in Module 1. As shown in the exhibit, New Tech's liquidation value of the assets dropped by 33% to $1,590,000 (from $2,399,000 as shown in Exhibit 2.1). With liabilities at $1,215,000, New Tech's total owners' equity or liquidation value becomes $345,000.

Going Concern Value

The going concern value relates to the ability or capacity of an asset to produce a stream of after-tax cash flows. For example, a person who invests $100,000 in Canada Savings Bonds does so to earn future cash receipts in the form of interest payments. Instead, the person may invest $100,000 in a business venture. The investor would therefore compare the worth of the future receipts (cash inflow) to the original investment (cash outflow). The going concern value approach is a future-oriented concept based on the principles of trade-off and risk. How much would one expect to earn from Canada Savings Bonds or from a revenue-generating asset — 5%, 10%, 15%?

Risk capital investors also examine the risk factor related to their investment. For example, an investor might be prepared to accept a 5% return on the relatively risk-free Canada Savings Bonds investment or 20% in a revenue-generating business that is riskier. Risk can be explained as the price tag on the sought-after economic return. The going concern value, therefore, looks at future cash flow expectations and the relative risk associated with the investment.

Exhibit 2.3 shows that in 1998, New Tech generated $204,000 in income after taxes. With depreciation and amortization of $200,000 added, the after-tax cash flow becomes $404,000 ($204,000 + $200,000). This information was previously presented in Exhibit 1.1 in Module 1. As shown in Exhibit 1.1, the $200,000 amount is made up of $110,000, $30,000 and $60,000 in depreciation and amortization for cost of goods sold, selling expenses and administrative expenses respectively. If investors want to realize a 20% return, New Tech's going concern value would be calculated as follows.

After-tax cash flow from operations	$ 404,000
Divided by capitalization rate[*]	÷ 20%
Going concern value	**$2,020,000**

Based on New Tech's future cash flow, as a *going concern*, the company is worth $2,020,000.

Discounted Cash Flow Value

Another approach for calculating the value of a business is the discounted cash flow method (DCF). The primary benefit of this approach is that it allows for changes and fluctuations in future cash flow over time. This method may be the most appropriate for a growing business. This approach is described on the following pages.

> Using the discounted cash flow calculation (as well as other methodologies) requires a good understanding of the time value of money concept. It is advisable to consult a financial advisor in the area of business valuation to assist you in determining the fair market value of your company's shares.

There are four steps involved in calculating the value of a business based on the DCF method. To understand more clearly the DCF methodology, these steps will be used for demonstrating New Tech's value.

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[*] The capitalization rate represents the rate of return required by the investors from New Tech. This rate is based on a number of subjective factors and conditions at the time of the valuation.

Step 1: Calculate New Tech's yearly after-tax cash flow (Exhibit 2.4).
Step 2: Calculate New Tech's projected residual value (Exhibit 2.5).
Step 3: Calculate New Tech's estimated market value (Exhibit 2.6).
Step 4: Calculate the investor's before- and after-tax return (exhibits 2.7(a) and 2.7(b)).

Step 1: New Tech's Yearly After-tax Cash Flow

The first step for calculating New Tech's market value is to determine its after-tax cash flow forecast for the years 1999 to 2003. As shown in Exhibit 2.4, New Tech's after-tax cash flow from operations increases from $530,000 in 1999 (the year the new product lin[illegible]troduced) to $2,308,000 by 2003. As shown in the exhibit, during the five-year period, New Tech will continue to invest in capital assets and in working capital. Investments in capital assets fluctuate from $1,100,000 in 1999 to $1,600,000 by 2003. As shown, working capital also fluctuates between $125,000 in 1999 and $240,000 by 2003. The lower portion of the exhibit shows how the increments in the working capital accounts were calculated and includes accounts receivable, inventory and accounts payable.

After adding the investments in capital assets and working capital to the after-tax cash flow from operations, New Tech would show a negative $695,000 cash flow in 1999 and positive cash flow between 2000 ($83,000) and 2003 ($468,000).

This discretionary after-tax cash flow for each year in the forecast period is then discounted to its present value using an acceptable discount rate, in this case, 20%. (See the discount factors used for each year to calculate the present value amounts between years 1999 and 2003.) As shown in the exhibit, the discounted cash flow for 1999 shows a negative $695,000 and gradually increases to a positive $468,000 by 2003.

The discount factor reflects the risk associated with New Tech's new product line. As shown, the projected cash flow loses more value as we reach the end of the forecast period. For example, cash flow generated during the second year of the forecast is discounted for two years only while cash flow from the fifth year is discounted for five years.

The present value of the cash flow for each year is than added to determine present value over the five years. The present value for the five-year forecast, using a 20% discount rate, is summarized below.

	Present Value (PV)
1999	- $ 579,000
2000	58,000
2001	87,000
2002	99,000
2003	188,000
PV	**- $147,000**

Typically, an equity investor would not receive a return on investment in the form of cash payments or interest over the life of the investment. The equity investor's return would be earned by proceeds on exit, and this depends largely on the negotiated nature and terms for each investment.

Step 2: New Tech's Projected Residual Value

At the end of the forecast period (in the case of New Tech, in 2003), New Tech will likely remain viable and continue to generate cash flow. The residual value represents the estimated present value of the after-tax cash flow expected to be earned beyond 2003. New Tech's residual value is calculated on the basis of an estimate of the maintainable or average cash flow expected to be earned by the company each year beyond the forecast period. As shown in Exhibit 2.5, the components of the residual value calculation include the calculation of the maintainable cash flow from operations beyond 2003 and the capitalization calculation.

Maintainable cash flow from operations. The cash flow, before income taxes for the last year of the forecast period (in the case of New Tech, 2003), is considered representative of the maintainable cash flow. As shown in Exhibit 2.5, New Tech's cash flow from operations 2003 is $2,308,000. This figure is drawn from Exhibit 2.4. This estimate is considered realistic unless there is information to assume otherwise. Income taxes and an estimate of annual ongoing capital spending (future average annual spending on equipment and other capital assets) are deducted to determine the maintainable after-tax cash flow. As shown in the exhibit, capital spending for each year *after* 2003 is estimated at $1,000,000. This amount will be spent each year to maintain operations at levels equal to the last year of the forecast, that is, 2003. As the exhibit also shows, there will be no increase in working capital accounts. It is assumed here that New Tech will remain at the 2003 level of operations, generating a steady yearly cash flow from operations of $2,308,000.

Capitalization calculation. As shown in the exhibit, the next step in calculating the residual value is determining the capitalization rate. Using capitalization is the same as discounting a maintainable cash flow in perpetuity (i.e. continually). This calculation is done by dividing the maintainable after-tax cash flow in the amount of $1,308,000 by an acceptable rate of return. In this case, the capitalization rate used for New Tech is reduced by 2% (from the 20% rate used in Exhibit 2.4) to 18%. The difference between the discount rate (used in Exhibit 2.4 for example) and the capitalization rate is adjusted for inflation, growth and risk. New Tech's residual value amounts to $7,267,000.

The last step in projecting New Tech's residual value is to calculate the present value of the $7,267,000 amount to be received in 2003, to the beginning of 1999 (the year of the investment by the risk capital investor). By using the same 20% discount rate as the one used in Exhibit 2.4, the present value of the residual value would be $2,920,000.

Step 3: New Tech's Estimated Market Value

Step 3 in the process involves the calculation of New Tech's estimated fair market value. As shown in Exhibit 2.6, the company's fair market value is estimated at $2,773,000 which reflects New Tech's five-year after-tax discounted cash flow (- $147,000 drawn from Exhibit 2.4) and its estimated residual value ($2,920,000 drawn from Exhibit 2.5). As shown in the exhibit, tax savings on existing assets and adjustments for existing debt and redundant assets are not applicable in the case of New Tech.

Step 4: The Investor's Before- and After-tax Return

The last step in the process involves the calculation of the investor's return on investment on a before- and after-tax basis. As shown in Exhibit 2.7(a), risk capital investors invested $600,000 in New Tech. It is assumed here that the $600,000 would be injected during the early part of 1999, say in January. As explained in a previous example, a capitalization rate will now be used to determine New Tech's residual value. But before this can be done, the total value at exit must be determined by multiplying the maintainable after-tax cash flow by a multiple. The multiple is equal to the inverse of a capitalization rate. In this case, a 12.5% capitalization rate is used which is equal to an eight times earnings multiple.

As shown in the exhibit, by using the eight times multiple, the value at exit is estimated at $10,464,000. It is assumed that the risk capital investor will have a 40% share in the company, which represents $4,186,000. By using a 47.5% discount rate, the present value of the $4,186,000 would be equivalent to the $600,000 investment made by the risk capital investors. This discount rate would therefore be considered the investor's before-tax internal rate of return (IRR). This return can be increased to satisfy the investor if the business owner is willing to relinquish more ownership to the risk capital investor. For example, in the case of New Tech, the 40% participation could be increased to perhaps 45%.

Similar calculations would have to be done to determine the investor's IRR on an after-tax basis. As shown in the upper portion of Exhibit 2.7(b), the tax portion is calculated. The investor would receive $4,186,000 at exit. The original $600,000 investment is then deducted from the cash proceeds which would leave the investor with a capital gain on the investment of $3,586,000. If the investor's taxable portion is estimated at 75%, this means that the taxable portion would be $2,689,000. If the investor is in the 50% tax bracket, an after-tax amount of $2,842,000 would be received. By using a 36.5% discount rate, the present value of the $2,842,000 would be equivalent to the $600,000 investment made by the risk capital investor. This discount rate would therefore be considered the investor's after-tax IRR.

Discount rate. The discount rate is determined subjectively and represents the rate of return investors will require to assume the perceived risk associated with achieving the level of forecast cash flow. The rate of return depends on many factors, including rates of return on alternative investments and industry, market and company-specific risk factors. The selection of appropriate rates of return is a subjective process requiring experience and judgment.

Ensure the income generated by non-operating assets is removed from forecast results. If this income is not removed, the value of the redundant assets will be counted twice to some extent, since the income will be included in the DCF calculation. The market value of the assets will then be added to the calculated DCF value.

5. Important Exit Strategies for Investors

The exit value depends on the planned exit strategy and the terms negotiated by you and the investor. The Negotiate the Deal module contains further information on exit strategies and options. The planned exit strategy must be realistic and reasonable. For example, if the exit strategy is based on the sale of all your company's shares, you must be willing to complete such a sale. A planned exit strategy which contemplates an initial public offering should be viewed with caution because not all companies have the potential to go public.

Today, the investor's exit value can only be roughly estimated based on the planned exit strategy and expectations of market conditions at the exit date. Certain financial information at exit, such as after-tax income, after-tax cash flow or earnings before interest, income taxes, depreciation and amortization (EBITDA), will have to be determined. Estimated exit values are frequently based on a combination of these measures. If the exit date falls within the forecast cash flow period, this information may be obtained from the cash flow you have prepared. If the exit date is subsequent to the forecast period, you will have to extend the forecast or estimate the required financial information on which the exit value will be based.

Initial public offering (IPO). If the exit strategy is to take your company public, then the exit multiple should be based on current IPO and public market multiples for comparable companies. IPO values are typically based on multiples of after-tax earnings and EBITDA. Earnings and EBITDA multiples can be determined by dividing the comparable public company's current stock price by its earnings per share and EBITDA per share as reported for the most recent 12-month period. The market-implied multiples should be adjusted subjectively to reflect the perceived difference between public companies and your company. It should also be adjusted for expected differences between the current public market conditions and conditions expected at the planned exit date.

Sale of all the shares of your company. If the planned exit date is close to the date of the residual value (one of the components of the DCF calculation), the residual value could be used as a proxy for exit value. If the exit date is not close to the residual value date, the exit value could be determined by applying multiples or capitalization rates used in the residual value calculation to the estimated maintainable discretionary after-tax cash flow at the exit date. The estimated exit value associated with the sale of your company may depend on the existence of a viable purchaser.

Sale of the investor's shares to a third party. Typically, the exit value is subject to the sale of the investor's shares to a third party and would be lower than the investor's prorated portion of the total value. This approach assumes the investor sells all the shares to a third party. This reduction is due to the lack of control over operations by a shareholder who holds a minority interest (less than 50% of the shares) and the lack of liquidity of a minority shareholding in a privately held company. The sale of the investor's shares will likely be more difficult as the new investor will want to know why the current investor wants to sell the shares.

Buyback of the investor's shares by your company. The exit value would be similar to the value determined for a sale of all the shares of your company as described above. It may be appropriate to reduce the purchase price to reflect the fact that your company will have to finance the transaction. The value of your company will be reduced because the financing capacity used to acquire the investor's shares will not be available to invest in future growth. The size of the value reduction will depend on the cost to acquire the investor's shareholding and the extent to which your company will require capital to finance future growth at the exit date.

Debt repayment. Funds received by the investor will include repayment of the outstanding principal at the exit date and participation in the equity value as negotiated (for a subordinated debt-type or similar instrument). The equity value on which the participation is based should be determined in accordance with the appropriate exit strategy as described above.

This part of the module has outlined some key considerations and issues to consider when preparing a valuation for use in obtaining risk capital financing. Valuation is a complex subject and a valuation performed without considering all issues can create further problems.

6. Conclusion

You have now completed the second step to become investor ready. In this module, you looked at:

- important information that should be presented to the investor to demonstrate the potential of your business venture;
- the logical approach that should be explored to demonstrate your company's investment potential and ensure you respond to your investor's needs when preparing the valuation of your business; and
- other approaches or methods in preparing a valuation of your business.

In the following module, Demonstrate Your Management Capabilities, you will take the next step to becoming investor ready by investigating how to demonstrate the strengths of your management team to potential investors. As you go through the module, pay particular attention to one item which is of great interest to investors — what are you doing about current or future weaknesses to strengthen your management team? The module focusses on all aspects of your company's management capabilities: past, current and future performance. Investors will pay very close attention to your management team, and you will have to demonstrate to them that your team will be able to generate the return expected from the business venture.

Case Example

This case example allows you to follow a fictitious company, New Tech Distributors Corp. (New Tech), as it seeks risk capital to finance its growth. The case shows how New Tech addresses the key elements presented in the Details *section of each module.*

If you have not already done so, read about New Tech's background and the challenges it faces in the Steps to Growth Capital Overview and Module 1, Identify Your Financial Needs. As well, you may wish to refer to the overview for an introduction to the overall structure of this program.

Much of the financial information provided in this case example has already been presented throughout this module. The purpose of reviewing the information one more time is to illustrate how financial needs and financing requirements can unfold within the context of a simulated company story.

Read about how New Tech identifies its potential for high growth and profitability as well as how it seeks risk capital to finance growth. You should refer to the Details *section of this module for a detailed explanation and calculations about New Tech's five-year pro forma income after-tax and cash flow estimates, and how the value of the company was calculated. Specifically, you should refer to exhibits 2.4 to 2.7 as you review New Tech's financial information.*

The Leg Work

Grant Argent (New Tech's financial advisor) informs Elizabeth Pratt (New Tech's accountant) that the management team must be able to convince investors that New Tech is a fast-growing business with excellent profit potential. This evidence has to be documented in a convincing manner in an investment proposal. To do this, Elizabeth needs to gather critical information that investors will need to examine before making their decision to invest in New Tech.

Stuart Chip (New Tech's president) and potential investors will need reliable information to put a value on the company's growth opportunity and expected return. Elizabeth will also have to determine the risk element and expected return on investment the investors want to earn. She asks Grant for some help with this particular segment of the evaluation.

Elizabeth starts by developing background information on New Tech's industry and how it is being affected by current economic trends. Who are New Tech's competitors? What are the economic trends in the industry? What are industry analysts predicting? Elizabeth gathers the information from a number of sources on the Internet, including New Tech's industry association, Industry Canada's data base (which provides data on a by-sector basis), Statistics Canada and various business periodical data bases. In addition, Elizabeth uses an industry market research report Stuart ordered last year from EconTechData. She also calls a few brokerage houses for reports on the industry. She quickly realizes that gathering the information is the easy part of the analytical process; sifting through it all and deciding what is pertinent and most relevant to their project is the most difficult.

Elizabeth is able to obtain information on industry shipments, the growth rate of the industry, major markets and key competitors. She collects enough information to confirm that the market for power modules is growing rapidly, and that New Tech is pursuing a conservative market share based on a production level of 2,500 power modules per year. Statistics Canada data indicates that shipments have increased by 25% over the last two years.

Elizabeth also has to provide information on New Tech's past operating and financial performance. When Stuart launched New Tech, he had prepared a business plan that was used to obtain bank financing. After going through the document, Elizabeth finds that the information is out-of-date; New Tech's current operating profile is completely different. She decides to meet Stuart and John Harley (New Tech's sales manager) to determine the type of information and the most relevant information that would be required to convince investors that New Tech is involved in a high growth industry with extraordinary potential. Stuart feels that Grant should also be present at the meeting. Before the meeting, Elizabeth circulates, to all members of the management team, the information and statistics she feels are pertinent for the discussion. She mentions at the meeting that she will be able to write the first draft on New Tech's historical performance. However, she points out that the information about New Tech's products and product life cycles in each of their respective markets including pricing strategy and management strengths and weaknesses will have to be drafted by different members of the management team.

The Competition

At the meeting, Grant indicates that New Tech will have to provide relevant information to potential investors. He stresses New Tech's strong competitive advantage and the reasons why it is unique. He is able to articulate his vision of New Tech's future and how he feels it can capture a larger share of the market. He feels that the size of New Tech allows the company to compete effectively against larger competitors.

Based on the industry information she obtained, Elizabeth indicates she is going to prepare a competitive matrix to compare the attributes of each competitor's products to those of New Tech. By benchmarking New Tech against its competition, Elizabeth is convinced that she will be able to clearly demonstrate New Tech's competitive advantage. Stuart believes that the competitive analysis and benchmarking, together with the other industry information Elizabeth has compiled, will satisfy the investors about New Tech's market opportunity and growth potential.

During the meeting, Stuart informs team members that the strategy behind the new product line is to focus on value-added components. The discussion also centres on the following points: market size and the demand for power modules, how the company is going to hire and train new staff for the new product line, the importance of securing the estimated gross margin on the new product line, the strategy for targeting new customers during the first year, and management's strong and weak points in each division (production, marketing, etc.) for coping with the launch of the new product line.

Grant and Elizabeth feel it is important to start gathering that information for the investment proposal (see the Build an Investment Proposal module). After the meeting, Elizabeth summarizes the key industry characteristics, New Tech's opportunities and threats within the industry and market environment. She writes down the specific actions the members of the management team believe are required in order to exploit New Tech's strengths, the specific actions required to minimize the identified threats and a plan to mitigate identified corporate weaknesses. She understands that investors will need to be well informed about New Tech's growth potential, the industry and the markets in which it competes. She also confirms that third-party industry information would help enhance the credibility of the investment proposal.

At the end of the meeting, Grant informs the team that he wants to continue discussing information that will have to be included in the investment proposal to show how the new product line will affect the potential market value of New Tech. This should be done the following week at the latest. Elizabeth informs group members that she will do some preliminary work dealing with this particular point.

Before the follow-up meeting, Elizabeth forwards some documents about the methodology for putting a price tag on New Tech's market value. This information is contained in exhibits 2.4 to 2.7.

Because of the complexity of the data contained in these documents, Stuart suggests that Grant be present at the meeting to comment on how potential investors will react to the information.

The Valuation

At the meeting, Grant explains that the material related to valuation is critical for both investors and the company. In general, it represents the application of valuation principles to produce a rough estimated value for New Tech's common shares today.

Valuation — the company's perspective

Before seeking risk capital, Stuart realized the importance of having a crisp understanding of New Tech's value of the shares to help determine the amount of ownership that may have to be given up in exchange for the risk capital investment New Tech requires. Going through the process of determining New Tech's value will also provide management with a clearer understanding of how investors will evaluate New Tech as an investment opportunity.

Grant points out that he is familiar with the discounted cash flow techniques used for valuing a business, and although he is aware of other methods, he feels that the discounted cash flow approach is the most appropriate for preparing the valuation estimate of New Tech's shares. Grant explains to the members of the management team the various steps involved in the process.

- Determine the present value of the after-tax cash flow of New Tech for a period of five years.
- Determine the residual value of New Tech at the end of the forecast period and then find the present value of this amount.
- Calculate New Tech's estimated market value by adding these two components and making other necessary adjustments (i.e. adding back redundant assets and tax shields on existing assets on hand at the end of the forecast period) to determine the total value of the shares of New Tech.

In calculating his preliminary estimate of the value of New Tech's shares, Grant essentially took the forecasted cash flows prepared by Elizabeth and discounted them to their present value by using an appropriate discount rate. The discount rate used was 20%. Grant subjectively determined (with input from New Tech's management) the 20% discount rate based on estimated required rates of return, as well as economic, industry and company-specific risk factors in effect at the time of the valuation estimate (Exhibit 2.4).

In determining the residual value of New Tech, which represents the value of New Tech for the period after the forecast, Grant used the cash flow from the final year of the forecast and assumed that this level could be sustained into the future. This cash flow was then capitalized (cash flow divided by capitalization rate) at a rate of 18% (20% discount rate less 2% representing the long-term inflation rate) and then discounted back at 20% to determine its present value at the valuation date. Based on this information, Grant estimated New Tech's value to be $2,920,000 (Exhibit 2.5).

Elizabeth and Grant then determined New Tech's estimated fair market value. This was done by adding the present value of the cash flow from operations in the amount of - $147,000 (drawn from Exhibit 2.4) to New Tech's estimated residual value in the amount of $2,920,000 (drawn from Exhibit 2.5). Since no adjustments were required (i.e. adding back redundant assets and tax shields on existing assets on hand at the end of the forecast period), New Tech's estimated fair market value was then estimated at $2,773,000 (Exhibit 2.6).

Valuation — the investor's perspective

At this point, Grant discusses the investor's return expectations. He feels that New Tech will fall short of its expected 40% after-tax return on investment.

Investors will evaluate the percentage of shares they require by looking at the potential return at exit. This exit might be achieved through an initial public offering, a sale of the whole company, a buyback or redemption of the investors' shares or other means.

Grant feels that potential investors would likely want to exit around 2003 when the total value of the company will have grown to $10,464,000 (Exhibit 2.7(a)). This is based on the after-tax cash flow of $1,308,000 multiplied by an eight times multiple. As shown in the exhibit, to satisfy investors' return needs, their required shares at the time of exit would be 40%, that is, $4,186,000. This means that the initial $600,000 investment by risk capital investors would generate, by 2003, an estimated after-tax cash flow of $4,186,000 which is equivalent to a 47.5% before-tax return on their investment.

Exhibit 2.7(b) shows that investors would earn a 36.5% return on an after-tax basis. After determining the capital gain on the investment and the investors' estimated tax portion, they would receive, at exit, net after-tax cash of $2,842,000. Based on the company's initial valuation estimate in Exhibit 2.4, it would therefore appear that investors would earn 36.5% (Exhibit 2.7(b)) on an after-tax basis from New Tech in exchange for the $600,000 investment.

This means that the 36.5% return would fall short of the 40% return expected by the investors. Would New Tech let go of more of their equity participation to the risk capital investors in order to satisfy their return needs? This would have to be discussed during the negotiation process. Other issues that would also be discussed are the discount rates (i.e. 18% and 20%) used in the calculation. These rates reflect management's views of the general economic, industry and company-specific factors that were appropriate to New Tech. Should these discount rates be altered? This would also be subject to debate during the negotiation process.

Grant expects the risk capital investor would want to earn an after-tax return of 40% to compensate for the risk. This reflects investor perceptions of the general economic, industry and company-specific risk factors facing New Tech at time of making the investment. Grant feels that this rate might be what investors feel is necessary to compensate for the risks associated with investing in New Tech, given these risk factors and the alternative investments available.

Now that New Tech's management understands the importance of an initial valuation and how investors would be viewing the company's investment potential, New Tech's management team is prepared to move on to one of the most critical steps in raising risk capital: demonstrating to potential investors that they have the management capabilities to implement and manage successfully New Tech's growth plan. This will be covered in Module 3, Demonstrate Your Management Capabilities.

Author's Note:

New Tech Distributors Corp. is moving toward its objective of demonstrating its investment potential to future investors. It has learned from this module:

- *the importance of preparing a credible investment proposal;*
- *the importance of properly estimating a valuation of the company;*
- *the importance of looking at growth opportunity through the eyes of potential investors;*
- *the importance of doing its homework in terms of knowing the industry, current trends and providing qualitative and quantitative information that may influence the decision of potential investors;*
- *that everyone on the management team must have a profound knowledge of the business they are in and have an appreciation for its growth potential;*
- *that the investment proposal is not just a dusted-off version of the business plan, but a document that addresses the specific needs of potential investors;*
- *that investors have different views of returns on investment, exit strategies and the degree of influence over the control and monitoring of a business; and*
- *the importance of understanding valuation from management's point of view as well as the investor's perspective.*

Myths

There is one rate of return on equity that can be used to determine the value of the shares of most companies.

The determination of appropriate rates of return required by investors is a subjective process. It is based on rates of return on alternative investments, industry, market, competitive and company-specific risk factors. Specific risk factors include the perceived risk of achieving the level of future cash flow.

I can determine the value of the shares of my company through the application of rules of thumb.

Rules of thumb represent general analyses that apply a basic multiple to a measure of activity, cash flows or asset values. Rules of thumb should not be used as a primary valuation technique but can be used as a "reasonableness" test of value conclusions determined through the application of other more rigorous techniques.

I can determine the price the investor will pay to invest in my company.

Each investor will have a different view of the value of your business. This view will be based on the perception of the future risks of your business and returns to be derived. In addition, price is not always equal to value due to differences in:

- the level of knowledge of your business's strengths, weaknesses, opportunities and threats;
- the desire to transact business; and
- the negotiating position and strength.

The income statement and statement of changes in financial position are the only financial statements required to determine the value of the shares of my company.

An analysis of your company's balance sheet is important in determining your value. Certain assets and liabilities may exist that may not be reflected in operating cash flows.

Frequently Asked Questions (FAQs)

Should I use third-party evidence to support my investment potential?

It is important to gather as much third-party evidence as possible to demonstrate the potential of your business. Prospective investors will gain significantly more confidence from information provided by a source considered to be objective and reliable.

How should a range of value be determined and how much equity will I have to give up?

The range of value will be determined relative to the future cash flow to be generated by your company. Based on the investment you require and the value of all your shares, you can determine the percentage of equity you will have to give up to obtain the required funds (investment/range of value = % equity you give up).

Should I consider using an independent expert to assist in the determination of value?

The use of an independent expert will allow you to separate emotional issues from practical, business-driven issues. An independent view will reassure you that appropriate valuation methodologies have been applied correctly and important factors have not been overlooked. In addition, you will benefit from the judgment and experience of the business valuator.

Can I determine the range of value of my company's shares by applying a multiple to historical earnings?

Value is based on the prospects of your business. The value of a business is related to its future ability to generate after-tax cash flow. Past results only guide you in determining prospective results. It is important to understand the influence of various factors on historical results to understand sensitivities and to estimate the future.

Exhibit 2.1
New Tech Distributors Corp.
Book Value

($000s)	1998 Actual	
Assets		
Current assets		
Accounts receivable	450	
Inventory	350	
Other current assets	334	
Total current assets	1,134	
Total net capital assets	1,215	
Other assets	50	
Total assets	**2,399**	
Liabilities and owners' equity		
Total current liabilities	815	
Total long-term debts	400	
Total liabilities	1,215	
Total owners' equity	**1,184**	← **Book Value**
Total liabilities and owners' equity	**2,399**	

Exhibit 2.2
New Tech Distributors Corp.
Liquidation Value

($000s)	1998 Actual	
Assets		
Current assets		
Accounts receivable	300	
Inventory	250	
Other current assets	200	
Total current assets	750	
Total net capital assets	800	
Other assets	40	
Total assets	**1,590**	
Liabilities and owners' equity		
Total current liabilities	815	
Total long-term debts	400	
Total liabilities	1,215	
Total owners' equity	**345**	← **Liquidation Value**
Total liabilities and owners' equity	**1,590**	

Exhibit 2.3

New Tech Distributors Corp.
Going Concern Value

($000s)	1998 Actual
Sales revenue	3,000
Total cost of goods sold	1,185
Gross margin	1,815
Operating expenses	
Total selling expenses	857
Total administrative expenses	555
Total operating costs	1,412
Operating income	403
Other income/charges	90
Income before taxes	313
Income taxes	109
Income after taxes	204
Add back: depreciation and amortization	200
After-tax cash flow	404
Divided by capitalization rate	20%
	2,020 ← **Going Concern Value**

Exhibit 2.4
New Tech Distributors Corp.
After-tax Cash Flow
(Step 1)

($000s)	1998 Actual	1999 Forecast	2000 Forecast	2001 Forecast	2002 Forecast	2003 Forecast
Sales revenue	3,000	3,900	4,700	5,800	6,700	7,700
Cost of goods sold	1,185	1,465	1,625	1,855	2,048	2,275
Gross margin	1,815	2,435	3,075	3,945	4,652	5,425
Operating expenses						
Selling expenses	857	1,320	1,320	1,380	1,475	1,545
Administrative expenses	555	690	765	820	890	960
Total operating expenses	1,412	2,010	2,085	2,200	2,365	2,505
Operating income	403	425	990	1,745	2,287	2,920
Other expenses	90	109	147	145	150	150
Income before taxes	313	316	843	1,600	2,137	2,770
Income taxes	109	111	295	554	736	952
Income after taxes	204	205	548	1,046	1,401	1,818
Add back: depreciation and amortization		325	375	400	430	490
Interest[1]		-	-	-	-	-
Cash flow from operations		530	923	1,146	1,831	2,308
Capital spending		-1,100	-740	-785	-1,100	-1,600
Incremental working capital[2]		-125	-100	-210	-525	-240
Total additional investments		-1,225	-840	-995	-1,625	-1,840
Cash flow with additional investments		-695	83	151	206	468
Discount rate factor (20%)		0.83333	0.69444	0.57870	0.48225	0.40188
Annual discounted cash flows		-579	58	87	99	188
Total present value for the five years		-147				
Incremental working capital						
Accounts receivable	450	550	650	750	900	1,050
Inventory	350	425	475	560	700	790
Total	800	975	1,125	1,310	1,600	1,840
Less: Accounts payable	550	600	650	625	390	390
Net increase in working capital for year	250	375	475	685	1,210	1,450
Previous year's working capital		250	375	475	685	1,210
Incremental working capital		125	100	210	525	240

1. No interest add back as it is assumed no adjustment for leverage is required.

2. Working capital increment is made up of (accounts receivable + inventory) - accounts payable. See detailed calculation of the net working capital increments in the lower portion of the Exhibit.

Exhibit 2.5
New Tech Distributors Corp.
Projected Residual Value
(Step 2)

($000s)	2003 Forecast
Sales revenue	[illegible]
Cost of goods sold	[illegible]
Gross margin	[illegible]
Operating expenses	
Selling expenses	[illegible]
Administrative expenses	[illegible]
Total operating expenses	[illegible]
Operating Income	[illegible]
Other expenses	[illegible]
Income before taxes	[illegible]
Income taxes	[illegible]
Income after taxes	[illegible]
Add back: depreciation and amortisation	[illegible]
Interest[1]	-
Cash flow from operations	[illegible]
Sustainable capital spending[2]	-1,000
Incremental working capital[3]	-
Total additional investments	-1,000
Cash flow with increased investments	1,308
Divided by capitalization rate (20% - 2%)[4]	18%
Residual value	7,267
Present value factor at 20%	0.40188
Present value of residual value	**2,920**

The shaded figures are drawn from exhibit 2.4, year 2003.

1. *No interest add back necessary as it is assumed that no adjustment for leverage is required.*
2. *Capital spending represents the amount New Tech would have to spend each year to maintain operations at levels equal to the last year of the forecast.*
3. *No increase in working capital is required as it is assumed that the company will remain at this level of operations, generating a steady cash flow of $2,308,000.*
4. *Capitalization rate is equal to the discount rate used in Exhibit 2.4, less an estimated 2% adjustment for long-term rate of inflation.*

Exhibit 2.6
New Tech Distributors Corp.
Estimated Market Value
(Step 3)

($000s)	2003 Forecast	
Present value of cash flow from operations	-147	(From Exhibit 2.4)
Add residual value	2,920	(From Exhibit 2.5)
Add estimated present value of tax savings on existing assets[1]	-	(Not applicable)
Add present value of losses carried forward	-	(Not applicable)
Total cash flow value	2,773	
Less existing debt[2]	-	(Not applicable)
	2,773	
Add redundant assets[3]	-	(Not applicable)
Estimated fair market value	**2,773**	

1. *Tax savings is based on capital cost allowance, which may be claimed on the existing assets in the final year of the forecast period.*
2. *No adjustment required as capital structure assumed to be optimal.*
3. *Redundant assets refer to those assets that are not required in the day-to-day operation of the business.*

Exhibit 2.7a
New Tech Distributors Corp.
Return on Investment Calculations to Investor
Before Tax
(Step 4)

($000s)	1999 Forecast	2000 Forecast	2001 Forecast	2002 Forecast	2003 Forecast
A. Before-tax rate of return					
Initial investment	-600	-	-	-	-
Cash distributions to shareholders[1]	-	-	-	-	-
Total value at exit					
After-tax cash flow[2]					1,308
Multiple[3]					8.0
Total value at exit					10,464
Investor's required share (40%)		-	-	-	4,186
Initial investment	-600				
Total cash flows	-600				4,186

Before-tax return to investor[4] **47.5%**

---

1. *Assumes that the investor will receive no other cash payments over the life of the investment.*
2. *Based on the after-tax cash flow from operations used for the residual value calculation in Exhibit 2.5.*
3. *Subjectively determined by the investor based on the expectation of market conditions at the time of exiting the investment (equivalent to capitalization rate of 12.5% give 1/8 times multiple.*
4. *Represents the before-tax internal rate of return (IRR) of the cash flows received by the investor.*

Exhibit 2.7b
New Tech Distributors Corp.
Return on Investment Calculations to Investor
After Tax
(Step 4) (continued)

($000s)

B. After-tax rate of return

Proceeds received on exit	4,186	(From Exhibit 2.7a)
Initial investment	-600	
Capital gain on investment	3,586	
Taxable portion (75%)[1]	2,689	
Investor's tax payable (50%)	1,344	
Gross proceeds received on exit	4,186	
Investor's tax payable[2]	1,344	
Net after-tax proceeds to investor	2,842	

	1999 Forecast	2000 Forecast	2001 Forecast	2002 Forecast	2003 Forecast
Initial investment	-600	-	-	-	-
Net after-tax proceeds to investor		-	-	-	2,842
Total cash flows	-600				2,842

After-tax return to investor[3] **36.5%**

1. *Assumes that the investor will have full capital gains treatment of sale of shares at the time of the initial public offering.*
2. *Assumes that the investor's marginal tax rate is 50%.*
3. *Represents the after-tax internal rate of return (IRR).*

Module 3: Demonstrate Your Management Capabilities

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Executive Summary

You have now reached the third step to becoming investor ready, Demonstrate Your Management Capabilities. This module shows how you can assure risk capital investors that you possess the required management capabilities to implement successfully the goals and strategies contained in your investment proposal. You will have to show potential investors how the members of your management team performed in the *past*, affirm that they *now* have the management skills to manage the company's key operating functions and, most important, affirm that they have the skills to realize successfully their business opportunity in the *future*.

In particular, this module shows how you can analyse your management team's strengths and weaknesses related to all aspects of your business' operating functions (e.g. marketing, production and finance). An investor wants to be assured that your management team has strong leadership, is competent, resilient, innovative and capable of realizing the goals and strategies presented in your investment proposal. If you are unable to demonstrate your management capabilities effectively, investors will not likely want to invest in your company, even if your business concept has market potential and is financially attractive.

In the Steps to Growth Capital Overview you were asked to consider the needs of investors in terms of the following questions.

- Have you demonstrated your financial needs?
- Have you demonstrated your investment potential?
- Is there a viable exit strategy for your investor?
- How will your investor monitor, influence and control your business?

The New Tech Distributors Corp. (New Tech) case example presented in earlier modules is used to show how management capabilities can be demonstrated. If you have read New Tech's case in the Steps to Growth Capital Overview. and in Module 1, Identify Your Financial Needs, and Module 2, Demonstrate Your Investment Potential, you are familiar with the company's background, financial statements, financial needs, financing requirements and investment potential.

Investors are interested in your past (track record), your present capabilities and future plans for dealing with your management capabilities (particularly your shortfalls). This module has been structured to respond to this interest. It covers four topics.

1. **Importance of management capabilities to investors.** An important issue prospective investors consider is the depth of the entrepreneur's capabilities. They will scrutinize your management skills to determine if you and your team have the ability to lead the company. Don't wait for a professional investor to perform a due diligence review to determine your management strengths and weaknesses. It could prove to be an unpleasant experience.

2. **Track record of your management team — your past.** Your management credentials include a summary of your team's experience and your company's past performance. If investors are assured of the experience, capability, skills and composition of your management team, they will examine your business venture with more confidence. Your management team's track record is one way to convince potential investors. A healthy past performance is certainly a plus factor. On the other hand, if management performance has been below par, you will have to explain the corrective mechanisms you will be implementing to do away with the weaknesses that may paralyze your business. This section

examines the type of information you need to expand on in your investment proposal to convince investors of your management credentials.

3. **Management skills and competitive assessment — your present.** This section shows how you can determine if you have the human resources to launch your business venture successfully. A self-analysis of your management skills can be a difficult process, but it must be done. This section presents a step-by-step approach that can help you analyse your management skills and the responsibilities needed to manage your company effectively. It also shows how you can demonstrate your competitive strengths to pinpoint your company's management capabilities (strengths and weaknesses). As a rule, your company's strengths should be fully exploited and you should show how you will reinforce areas where your company is most vulnerable. Investors realize that your company has the best potential for offensive attack in areas where it is strong and rivals are weak.

4. **Management capabilities needed to implement your goals and strategies — your future.** This section shows how you can demonstrate to potential investors that your team members have the capabilities to implement successfully the goals and strategies included in your investment proposal. It illustrates how you can translate your past performance and present capabilities into identifiable and meaningful results. Goals and strategies define the types of decisions you should take to achieve the desired performance levels in each key operating function of your company. Investors will have to determine whether you have the right organizational structure, the complementary management capabilities, employee skills and enthusiasm to succeed.

> "A manager has the task of creating a true whole that is larger than the sum of its parts, a productive entity that turns out more than the sum of the resources put into it."
> Peter Drucker

Details

1. Importance of Management Capabilities to Investors

Poor management is probably the reason most businesses fail. Superficially, failures can be traced to poor cost accounting systems, overextension of credit, poor organization, inadequate sales and too much inventory. These are only symptoms of a much larger problem that can usually be traced to poor management. Risk capital investors are aware of this and need to learn about the people managing the business they will be investing in. While investors are generally risk tolerant, they will not put their resources (equity) at risk unless they are convinced their investment will be properly managed and, most important, be profitable.

As mentioned in the previous module, professional investors are much like seasoned horse-race betters in seeking out a winner. According to *Pratt's Guide to Venture Capital Sources*, "Venture capitalists say they prefer a grade A entrepreneur [jockey] with a grade B business idea [horse] to a grade B entrepreneur with a grade A idea. And it is generally a strong management team not a lone entrepreneur that they back."[1] In other words, risk capital investors put a higher priority on the management team than on products or services.

When investors say they want top managers or an effective management team, there is a big emphasis on the plural. Investors don't care too much for companies founded and operated by a single entrepreneur, no matter how savvy that individual might be. They realize that a one-man band tends to run into limitations by virtue of the fact that a single individual can only accomplish so much in a 24-hour day. In the view of investors, the entrepreneur who tries to be all things to all people winds up being of diminished worth overall.

As far as investors are concerned, the antidote to the one-man band syndrome is a strong *management team*. In their view, the management team — usually three to six executives — reduces risks associated with the one-man band in two key areas. First, a management team ensures that all important management functions — production, marketing, sales and finance, among others — will be effectively managed. Second, a team ensures that the business can survive the loss of a key person due to an illness, an accident or recruitment by a competitor.

Bringing together a winning team, as any sports fan knows, is an important task. A team needs to be skilled, balanced, driven and compatible. Of equal importance, investors realize that three key ingredients make an effective team: its composition, structure and process.

Composition refers to the collective characteristics of top team members, such as their values, experiences, skills and abilities. They will regard team diversity as critical. Diversity encompasses both personality factors (values, beliefs, cognitions) and related experience (age, tenure, functional background, education).

Structure deals with the roles of each member and the relationships among those roles. An effective structure will generate the desired level of synergy. Central to this is the mutual dependence of the team members.

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[1] A. Dingee, B. Haslett and L. Smollen, "Characteristics of a Successful Entrepreneurial Management Team," *Pratt's Guide to Venture Capital Sources* (New York: Securities Data Publishing Inc., 1996), p. 23.

Process means the interaction among team members as they make important decisions. This includes the attraction to the group members and consensus building. This has to do with how they are able to agree on important decisions.

The investment proposal should emphasize how your team's abilities contribute to the success of your business venture, and how they complement each other to the advantage of the company. Failure to provide adequate details about your management team will only raise eyebrows among potential investors.

Entrepreneurs can add considerable value to their management team by forming a board of directors with reputable and credible outsiders. Outside board members impress potential investors because they can legitimately help a growing company grapple effectively with the many challenges of the early years. You may want to seek out advisors with abilities in areas where your team is weak, who have a reputation for integrity, foresight and success. This may include part-time advisors such as your legal counsel, financial advisors, accountants or even your potential investors.

Some investors may even want to have input in the selection of team members, including the appointment of the members on your board of directors. Many investors prefer to play a passive role. However, the degree of investor involvement in this process is usually based on their perception of your team's management capabilities. If they have confidence in your team members, they will allow existing management to continue. If not, they will want to be active in certain roles such as policy decision making, financial problem solving and recruitment of managers. This may be good for you, especially if investors complement a specific skill or provide growth opportunities which you would otherwise not be able to exploit.

It is also important to realize that your company may be experiencing change as a result of the new venture. Team members may not be performing the roles for which they were best suited in the past, and they may require a realignment of duties. Some members of the existing team may leave, particularly if they are not qualified. New team members with specific skills may have to be recruited. Some investors ask for written job descriptions of the team members to establish a clear division of responsibilities. This is an important step to pinpoint *who* will do *what* and *how* the roles will overlap. It will also help investors assess your management team's ability to manage every key operating function of your company.

> "The primary skill of a manager consists of knowing how to make assignments and picking the right people to carry out those assignments."
> Lee Iacocca

Change is an integral part of a growing business. Changes in management should have a positive impact on your organization because they are intended to put key members of your team where they are best qualified. For this reason, many companies rebuild their management team on a continual basis to adjust to changing economic, industry and market circumstances. You should therefore be prepared to adapt your company to your changing environment.

2. Track Record of Your Management Team – Your Past

A common set of functions must be performed in every company. Well-managed companies make sure that all of them are properly executed. Functions may vary from organization to organization and their relative importance may also change; however, the same basic requirements remain since all of them have to:

- produce a product or provide a service (production/operations);

- sell and service it (marketing/distribution);
- develop and improve it (research and development [R&D]/engineering);
- manage money (finance/accounting);
- perform the work in all functions (human resources) effectively; and
- lead the business (management).

> If you are launching a **new business**, the contents of the following section will not have as much relevance in view of the fact that you would not have any disclosures to make about your history. As a promoter of a new business, you would have to emphasize your team members' management performance and accomplishments with previous businesses.

If properly analysed and presented, *historical performance* serves to convince your potential investors of the effectiveness of your team. Investors will gauge team members from three angles: overall performance, operating performance and market performance.

Overall performance shows how your business deployed its resources in the past. Useful business ratios to gauge overall performance include those that measure profit and cash flow performance, liquidity and debt ratios, sustainable growth rate, financial health score and productivity of your assets.

Market performance gauges your company's position within your industry. For example, did you lose, maintain or improve your market position? Were you able to manage your business under adverse competitive conditions? How? Your market performance can be measured by using market share measurement, product performance (quality, acceptability), selling price and image.

Operating performance deals with the managerial and technical abilities of your team members. Pertinent information on managerial performance relates to the more important operating functions of your business such as:

- marketing/distribution (product acceptability, distribution efficiencies, sales performance);
- production/operations (fixed and variable expenses, cost of raw materials, use of plant capacity, capital assets turnover, inventory turnover);
- finance/accounting (cash conversion cycle, liquidity position, accounts receivable turnover, working capital turnover); and
- human resources (management skills and diversity, employee turnover, quality of work force and general working conditions).

As mentioned in Module 2, Demonstrate Your Investment Potential, all organizational and management functions are important for a business to succeed, and each function requires specific management skills and talent. Analysing your historical performance helps investors identify management's strengths and weaknesses. As indicated in the previous module, a *strength* is something your company is good at, or that gives you a competitive edge or advantage. A *weakness* is something your company does poorly and may place your business at a competitive disadvantage. This diagnostic analysis will help you capitalize on your management strengths and find solutions to overcome your weaknesses.

To help you analyse each key functional area (i.e. marketing, production), a functional-area, resource-deployment matrix may help to pinpoint your historical spending and the relative importance of each function. If the information is available, you may want to compare each function against your more important competitors.

The analysis of your management capabilities will be examined from three angles. This section, Track Record of Your Management Team — Your Past, examines four years, from 1995 to 1998. Section 3, Management Skills and Competitive Assessment — Your Present, focusses on 1998. Section 4, Management Capabilities Needed to Implement Your Goals and Strategies — Your Future, looks at the years 1999 to 2003. Whenever applicable, quantitative examples for New Tech are used to demonstrate what type of information can be presented for analysing your management capabilities. The five operating functions that will be examined in this module are:

- marketing/distribution;
- production/operations;
- accounting/finance;
- R&D/engineering; and
- human resources.

Marketing/Distribution

Marketing/distribution means moving your goods and services from your plant to the ultimate users. It starts with finding out what your customers want or need and whether your product or service can be sold at a profit. This requires market research, identifying the market segment, developing products, testing customer reaction, working out costs, determining distribution and service requirements, and deciding on advertising and promotional strategies. This is particularly challenging because these activities have a direct influence on the all-important line on the income statement, sales revenue.

The resource deployment matrix for the marketing/distribution function presented in Table 3.1 shows your report card or how well this function performed during the last four years for certain key success factors such as sales revenue and market share. As shown in the table, the focus of your analysis should be on market information, financial deployment and operating performance (efficiencies). The lower portion of the table illustrates the historical efficiencies of your marketing/distribution function related to sales revenue.

Table 3.1: Resource Deployment Matrix for Marketing/Distribution

	1995	1996	1997	1998
Internal and market information				
1. Sales revenue ($)				
2. Number of units sold				
3. Market share (%)				
4. Number of retailers				
Financial deployment ($)				
1. Sales activities				
2. Distribution activities				
3. After-sales service activities				
4. Market research activities				
Operating performance as a % of sales revenue				
1. Salaries				
2. Advertising				
3. Promotion				
4. Distribution				

Here is a sample of important questions the marketing/distribution function should focus on.

- Why did your sales performance (for each product line) increase? Decrease?
- What was your growth rate for each product line for your units? For your revenue?
- To what extent has your firm established a strong market share in the total market and key submarkets?
- How effective was your market research system?
- How did your customers respond to the quality of your products and services?
- How skilled were you in determining your pricing strategies?
- What was the productivity of your sales force? Your average sales revenue per individual?
- How effective were your advertising and promotional programs?
- Were your customers satisfied with your after-sales service? Why?
- Can you comment on the efficiency and effectiveness of your distribution channels?
- Can you comment on the turnover rate of your marketing and sales personnel?

Production/Operations

While marketing is considered a *revenue centre*, its counterpart, production/operations, is a *cost centre*. Most expenses of production-oriented businesses are incurred at the production level, in such areas as plant expenses, productions costs, maintenance, raw material purchases, insurance, cost of inventory and utilities. Cost of goods sold, which includes purchase and transportation of raw materials and production costs, is a sizeable portion of a company's overall costs. In fact, for a production-oriented business, it could account for as much as 80% of total costs. For example, for every sales revenue dollar, about $0.80 is spent on the production of goods; the rest is for selling (marketing) and administrative expenses. This part of the analysis should therefore focus on how efficient your management team was in producing goods at competitive costs and superior quality.

The resource deployment matrix for the production/operations function presented in Table 3.2 shows your report card or how well this function performed during the last four years for certain key success factors such as plant efficiencies (cost per unit) and effectiveness (product quality), plant capacity and level of production. As shown in the table, the focus of your analysis should be on efficiencies and effectiveness and the costs related to the buying and manufacturing functions. The lower portion of the table illustrates the historical efficiencies of your production/operations function related to sales revenue.

Table 3.2: Resource Deployment Matrix for Production/Operations

	1995	1996	1997	1998
Production information				
1. Plant capacity (%)				
2. Number of units produced				
3. Cost per unit ($)				
4. Reject rate (%)				
Financial deployment ($)				
1. Purchases				
2. Freight in				
3. Salaries and wages				
4. Quality control				
Operating performance as a % of sales revenue				
1. Purchases				
2. Freight in				
3. Salaries and wages				
4. Quality control				

Production/operation's prime objective is to make a product that meets the needs of marketing (its selling agent) at the best possible price. Because of the significance of these costs, it is important to use break-even analysis to show the profit performance and the relationship between revenue and costs (fixed and variable). This type of analysis would show the historical effectiveness of your production team in determining its level of productivity, its performance in supplier relations and the way you have managed your plant capacity to contribute to your competitive advantage.

Here is a sample of important questions that the production/operations function should focus on.

- What type of analysis was used to determine your plant capacity?
- How did you go about determining the state of your manufacturing technology?
- What are your fixed and variable costs? How much is it for each unit?
- What is your historical break-even point? How far were you from your profit break-even?
- Who are your suppliers? What is your relationship with them? Why are they reliable?
- What is your cost of raw materials? What is it on a per unit basis? How does this cost compare to your major competitors?
- How much inventory do you have in stock? In raw materials? In process? In finished goods? Describe the inventory management system you are using to keep your inventory at a low level.
- Is your plant unionized? What is the climate between your management and the union?
- What quality control mechanisms have you got in place? What have you done to maintain superior quality?
- Did you obtain your ISO 1900 certification? Is it important for your industry? Why?

Accounting/Finance

Accounting can be thought of as the scorecard of business. It translates the activities of your company into a set of objective numbers that give information about your firm's performance, problems and prospects. On the other hand, *finance* involves the interpretation of these accounting numbers for the assessment of performance and the planning of future actions.

Investors realize that finance affects all segments of your business activities. Because you will be acquiring funds, allocating resources and tracking performance, financial activities become a focal point for managerial attention, decision making and accountability. The methods used in performing these functions are important and relevant to investors, creditors and regulators. If accounting and finance are properly executed, investors can get a better reading of the risks their capital is exposed to and the returns they may realize.

Investors will want to obtain information about the activities of two broad finance functions: the controller's department and the treasurer's department.

The **controller** looks after the recording, monitoring and controlling of the financial consequences of your past and current operations, and analyses operating and financial data. Essentially, it means dealing with your reporting system since investors will want to know the accuracy, consistency and reasonableness of your information. They will want to ensure that your reporting system complies with the generally accepted accounting principles.

The **treasurer** deals with external activities, that is, the company's relationship with lenders, shareholders, security markets and regulatory agencies.

The resource deployment matrix for the accounting/finance function presented in Table 3.3 shows your report card or how well this function performed during the last four years for certain key activities such as the payment of dividends to shareholders, the raising of debt and the amount of funds generated by your business.

Your presentation should focus on the analytical side to demonstrate how skilled you are in presenting and analysing financial information (i.e. financial ratios). This is an área that investors are keenly interested in. The lower portion of the table illustrates the company's historical profit related to sales revenue.

Table 3.3: Resource Deployment Matrix for Finance

	1995	1996	1997	1998
Financial information				
1. Payment of dividends				
2. Total debt				
3. Total investments				
4. Cash flow from operations				
Financial ratios (times)				
1. Debt-to-equity ratio				
2. Totals assets turnover				
3. Current ratio				
4. Times interest earned				
Operating performance as a % of sales revenue				
1. Gross margin				
2. Operating income				
3. Income after taxes				

Here is a sample of important questions that the accounting/finance function should focus on.

- Can you describe the accounting principles regarding your depreciation?
- Have you attached your company's five-year financial statements?

- Can you comment on your company's credit rating?
- What is your relationship with your major lenders? Your investors?
- How do you manage your cash? What is your liquidity position?
- How does your cost of financing relate to your return on investment?
- What type of financial and capital budgeting procedures do you have?
- Who are your external auditors? Can you comment on your audit practices?
- What payment terms do you offer your customers?
- What payment terms are offered to you by your suppliers?
- What is your executive compensation plan? What benefits do you offer your employees?

> The response, "You need more equity," is an easy way out for a banker or investor who is afraid of being candid. Don't be afraid to ask what the real underlying concern is and for suggestions about how to fix the problem(s).

R&D/Engineering

The research and development (R&D)/engineering function can help you become more competitive in two ways. First, it can lead to new or improved products for marketing. Second, it can lead to the development of improved manufacturing or materials processes that will help you to gain cost advantages through production efficiencies (which could help to improve prices and margins). Obsolescence of process, product or equipment is a very real possibility and investors know it. Therefore, R&D/engineering can provide significant strength for your business. Investors should be given assurances that you have kept your company technologically current.

Successful companies invest in R&D to find more cost-efficient manufacturing methods and ways of improving the quality of their products. This helps them maintain a competitive edge, and to ensure their products remain current technologically. Research and development remains an important role in the growth and survival of businesses, and acts as a signal to the prospective investor that you and your management team are committed to the growth and success of your project.

The resource deployment matrix for the R&D/engineering function presented in Table 3.4 shows your report card, or how well this function performed, over the last four years in certain key areas such as number of patents and number of new products. As shown in the table, the focus should be on basic research, new product development, product improvement and process improvement. The lower portion of the table illustrates the historical efficiencies of your R&D/engineering functions related to sales revenue.

Table 3.4: Resource Deployment Matrix for R&D/Engineering

	1995	1996	1997	1998
R&D Information				
1. % dollars from new dollars				
2. Number of patents				
3. Number of new products				
4. Turnover of personnel				
Financial deployment ($)				
1. Basic research				
2. New product development				
3. Product improvement				
4. Process improvement				
Operating performance as a % of sales revenue				
1. Basic research				
2. New product development				
3. Product development				
4. Process development				

Here is a sample of important questions that the R&D/engineering function should focus on.

- What have been your research capabilities within your firm? What are they now?
- Can you comment on your ability to meet your design goals and customer requirements?
- Can you comment on the quality of your physical laboratories and testing facilities?
- What percentage of your operating income or sales revenue is allocated to your R&D effort? Were your R&D scheduled objectives and plans achieved?
- How many employees have been working in your R&D department? What are their qualifications?
- Is the work environment in the R&D department suited to creativity and innovation?
- Is your company affiliated with any independent or government laboratories, research institutions or consultants?

> Do not underestimate the value of continued R&D to your products, but make sure you are getting tangible results. The growth and success of your company depend on it.

Human Resources

It is important that you have effective policies in such areas as training and development, salaries and compensation, performance appraisal, recruitment, teamwork and team-building approaches, and supervision. Human resources management can easily provide competitive advantages for your firm by helping you attract and keep high-quality, highly productive, loyal employees and managers. Your organization's structure, climate and culture can also be a key advantage.

The resource deployment matrix for the human resource function presented in Table 3.5 shows your report card, or how well this function performed, during the last four years for certain key success activities such as employee productivity and morale, training and development, and employee benefits. The lower portion of the table illustrates the historical amount of money spent on training in relation to sales revenue.

Table 3.5: Resource Deployment Matrix for Human Resources

	1995	1996	1997	1998
Human resource information				
1. Number of employees				
2. Turnover of personnel				
3. Absenteeism rate				
4. Average age of employees				
Financial deployment ($)				
1. Salaries				
2. Training and development				
3. Employee benefits				
4. Employee relations				
Operating performance as a % of sales revenue				
1. Salaries				
2. Training and development				
3. Employee benefits				
4. Employee relations				

Here is a sample of important questions that the human resource function should focus on.

- What has been the evolution of your organization's structure, culture and value system?
- How effective are your corporate-staff support systems?
- What is the profile of your employees?
- How effective have your relations been with employee unions?
- How effective are your personnel relations policies, staffing, appraisal and promotions, training and development, and compensation benefits?
- Can you comment on your corporate image?
- How productive are your employees?
- How creative and innovative are your staff?

> It is better to excel at one trade than to perform all things at an inferior level. You should evaluate your own skills and recruit other key people or advisors who can strengthen your weak areas. A strong management team is one of the keys to your continued success. Also, let's not forget the old saying:
> "Our most important assets are our people."

3. Management Skills and Competitive Assessment – Your Present

Now that you have demonstrated your historical management performance for the last several years, your next step is to show to what extent your management team has the required experience and complementary business and management skills to launch the new business venture successfully, and to assess your company's competitive position and strength.

Management Skills Compared to Needs Analysis

Leadership is an important element of the investment proposal that will help convince investors that a business opportunity can be brought to financial success. You must be prepared to show potential investors that your management team (just like the jockey) possesses the required skills to implement your business venture successfully. The analysis of your management skills can be done in six steps.

Step 1: General List of Management Skills. The first step is to make a list of the generic management skills that your management team (chief executive officer, vice-presidents of marketing, production, controller, research and development, etc.) will need needed to operate effectively the basic business functions (production, marketing). This first step can be done through a brainstorming session involving all key members of the management team. Here are a few examples of some of the required skills for various functions.

Chief Executive Officer (CEO). Transformational leader, visionary and culture builder. Strategic thinker with good knowledge of each area of the firm's marketplace and operating functions. Strong leadership qualities and good communication skills with the ability to organize, direct and motivate people, to resolve conflict and keep the organization moving toward its goals. The driving force that makes the organization work. Strongly committed to the products or services, and an impassioned believer in the company's vision and mission. Must be able to provide the necessary force to propel product development and marketing.

Marketing Vice-President. Creative insight to discover opportunities, strengths and advantages. Expert in marketing and sales, capable of identifying markets and customers, spotting trends leading to new opportunities, developing and implementing marketing strategies including advertising and promotional plans. Strong understanding of how to gauge customer needs and tastes. Well-informed on the product, distribution, packaging, service and price effectiveness required to compete in the marketplace. Selling skills required to build and train a sales force, knowledgeable in sales compensation and able to motivate a sales staff. Working knowledge of territory management.

Production Vice-President. Competencies in low-cost manufacturing, quality control and design capability. Ability to solve production problems in product manufacturing. Excels in the supervision of a large number of people and capable of implementing change. Knowledge in the area of team building and ability to promote teamwork. Mastery of important manufacturing technology. Capable of implementing and managing total quality control mechanisms (ISO 9000 type). Knowledge in production planning and scheduling, just-in-time, quality assurance and process innovation. Purchasing and materials management qualities. Effective in negotiating with suppliers for high-quality materials at lowest possible cost.

Controller. Facilitator with good understanding of all operating functions. Abilities in communication and motivation. Public relations qualities and writing skills. Ability to focus on cash needs and tackle required fund-raising activities in advance of critical situations. Strong analytical skills in financial management, and ability to gauge investment proposals through cost-benefit analysis techniques and time value of money yardsticks. Ability to prepare and communicate projected financial statements. Capable of asking pertinent questions that lead to new ideas and opportunities. Must be able to prepare and analyse detailed budgets, handle payroll, process accounts payable and receivable, maintain the general ledger and provide monthly financial reporting. Must also establish internal controls for expenses, administer contracts and perform (in conjunction with the vice-president of production/operations) the purchasing function.

Research and Development Vice-President. Performs research activities in product/service R&D and process R&D. A skilled innovator in production improvement, able to identify and suggest low-cost marketing and manufacturing strategies. Ability to work with the marketing, sales and customer service departments to transform discoveries into marketable products and to spot emerging product opportunities from internal and external information. Must produce basic design for new products and work with product manufacturing to get products into production efficiently and effectively.

Step 2: Customize the List. Since every firm and industry is different, you must now identify the core competencies that are critical and essential for your particular firm. You should review each skill identified in Step 1 and ask pertinent questions.

- Does this skill apply to this firm? How important is it?
- Do you need the skill now, or at some time in the future? If needed in the future, what milestone will be the key indicator?
- What unique business and management skills are needed in each operating function?

Step 3: Take an Inventory of Existing Skills. List the members of your management team. Next to each name, list the individual's experience, education and skills, together with a candid analysis of the results attained while performing their functions and the results that should have been attained. In the case of a start-up company (or a person that is not yet with your company), list the results expected to be attained by these individuals. To make the process meaningful, you may want to have team members describe and evaluate each other. Results can then be presented in a final list that clearly shows the group's skills now, and those required in the future.

Step 4: Use a Matrix to Compare Available Skills to Needs. Using a matrix such as the one presented in Figure 3.1, Matching Management Skills to Needs, map the results of your findings. The presence or absence of skills and the evaluation of performance should be included in the matrix. As shown in the figure, the skills needed to operate the firm efficiently and effectively are listed horizontally at the top of the matrix (there could be more). Note that the skills required for the operating functions, such as marketing, sales and production, are not shown. These would have to be added to your matrix to make it more complete and pertinent. Make sure the list of skills deals with both management skills (e.g. planning, organizing, communication, leading and controlling) and business skills (e.g. marketing, selling and distributing).

As shown in the figure, the members of the management team are listed vertically on the left side of the matrix. You should enter, in the appropriate cell, the score for each individual in every area deemed important to your organization. The scores range from 0 (indicating no experience and skill) to 5 (indicating a high degree of experience and skill). A zero means the skill was deemed important for the function and person, but is not yet present in the organization.

Figure 3.1
Matching Management Skills to Needs

Functions/Skills	Leadership	Motivation	Initiating Change	Team Building	Decision Making	Planning	Communications	Managing Growth	Collaboration	Strategic Thinking	Average
CEO	5	4	3	2	5	4	5	5	5	2	**4.0**
V.P. Marketing	4	5	3	2	4	4	4	4	4	3	**3.7**
V.P. Production	3	3	4	3	5	3	3	4	3	1	**3.2**
V.P. Finance	4	2	2	1	4	4	4	2	4	2	**2.9**
V.P. R&D	2	4	3	2	4	5	3	2	2	1	**2.8**
Average	**3.6**	**3.6**	**3.0**	**2.0**	**4.4**	**4.0**	**3.8**	**3.4**	**3.6**	**1.8**	

Step 5: Evaluate the Matrix. The next step is to analyse the matrix. This can be done fairly easily. A column with low marks (0, 1, 2 or 3) would be regarded as a weakness that needs to be resolved. As shown in the example matrix, the one skill that needs to be improved across the board is strategic thinking (average of 1.8). You may want to establish an acceptable benchmark for each skill. Once the matrix is complete, it is relatively easy to pinpoint which skills need to be upgraded for each individual.

Step 6: Make Decisions about the Needs Required. Once your self-analysis is complete, take the action necessary to correct the deficiencies. People with the needed skills can be hired, training activities can be started for those already on the team, and the need for one or more people with specialized skills can be identified in the investment proposal.

Competitive Strength Assessment

This competitive strength assessment looks at each "key activity" performed in your business that is critical to its long-term success, viability and profitability. These activities are examined in terms of their strengths and weaknesses, and compared with key competitors. Particular elements to single out for this type of evaluation are the following:

- How strongly is your firm holding its present competitive position?
- Can your firm's position be expected to improve or deteriorate if the present strategy is continued (allowing for fine-tuning)?
- How does your firm rank relative to key rivals for each important measure of competitive strength and industry key success factor?
- Does your firm have a net competitive advantage? Disadvantage?
- Does your firm have the ability to defend its position in light of industry driving forces, competitive pressures and the anticipated moves of rivals?

An example of such an assessment is presented in Figure 3.2, Competitive Strength Assessment. Industry and competitive analysis reveals the key success factors and competitive strength measures that will separate winners from losers. It's a four-step process.

1. Make a list of the industry's key success factors and measures of competitive strength or weakness (six to 10 measures are usually sufficient).
2. Rate your firm and your key rivals on each factor (give each a rating of 1 to 10, with 1 being the lowest and 10 being the highest).
3. Add the strength ratings to get an overall measure of competitive strength for each competitor.
4. Draw your conclusion about the size and extent of your company's net competitive advantage or disadvantage, noting areas where the competitive position is strongest and weakest.

Figure: 3.2
Competitive Strength Assesement

Key Success Factor/Strength	**New Tech**	**Rival 1**	**Rival 2**	**Rival 3**	**Rival 4**	**Rival 5**
Quality/Product Performance	10	10	5	2	8	8
Reputation/Image	9	10	6	2	9	8
Technological Skills	8	9	3	5	7	9
Advertising Effectiveness	8	7	2	1	6	6
Distribution Efficiencies	8	8	4	5	8	8
Financial Resources	8	10	5	2	5	7
Relative Cost Position	5	9	6	5	5	7
Price Competitiveness	7	8	3	4	8	7
Overall Strength Rating	**63**	**71**	**34**	**26**	**56**	**60**
Rating Scale : 1 = weak; 10 = strong						

As shown in the figure, New Tech's score is 63, which signals a greater net competitive advantage over Rival 2 (with a score of 34) and Rival 3 (with a score of 26). Knowing where your company is competitively strong and where it is weak is essential in crafting your goals and strategies. This grid shows investors where and how you will strengthen your long-term competitive position and whether you have the management and business skills to do it.

4. Management Capabilities Needed to Implement Your Goals and Strategies – Your Future

Now that you know your historical managerial performance and have gauged your management skills and competitive assessment for your marketing, production, finance, and research and development functions, and have matched them with your competitors, the next step is to determine how you are going to capitalize on your management's strengths and opportunities. You will have to demonstrate whether your management team will be capable of meeting the challenges it faces for each operating function.

As you will see in the next module, Build an Investment Proposal, the proposal contains projected financial statements. You will now have to convince the risk capital investors that the members of your management team possess the skills, knowledge and competencies to realize the stated goals and effectively implement the various strategies for each operating function.

To find out if you have the required skills, you should analyse the effectiveness of your management team, which may identify a need to realign some responsibilities. Any changes you make should be designed to strengthen your management team's overall management capabilities.

If you are unable to strengthen some of the weak areas, you should consider recruiting qualified individuals to fill these gaps, so you present a strong and cohesive management team to your potential investors. This will be covered in Module 6, Meet Potential Investors. Your team should include experienced and qualified people responsible for each of the key functional areas discussed in this module.

Before proceeding with the drafting of your investment proposal, you should be able to answer important questions about your team's management and business skills. Ask yourself the questions covered in the following sections for each key executive in your company in terms of how they will respond to the challenges presented in your investment proposal, which will be covered in Module 4, Build an Investment Proposal.

You should examine all the financial statements contained in your investment proposal and extract the more important indicators that will require some explanation in terms of how you will be able to meet your growth head on. If you do not bring out these indicators and related explanations as to how you expect to meet the challenges, your investors will surely ask for some explanation during initial discussions or in the due diligence review. Approach investors in a proactive manner rather than being reactive. To demonstrate the effectiveness of your management team, you may also want to compare your performance with the more important competitors by using the benchmarking management technique. *Benchmarking* is an approach that compares the performance of your products/services with those of your market leaders. These leaders may or may not belong to the same commodity sector.

Corporate Management Capabilities

The important skill required in assembling a core executive group is discerning what mix of backgrounds, experiences, know-how, values, beliefs, styles of managing and personalities will contribute to the successful execution of your strategies. The personal "chemistry" needs to be just right, and the talent base needs to be appropriate. Until all the key functions are filled with the right people (or such people have been identified), it is hard to implement the intended strategy and proceed at full speed.

A strong management team is probably the single most important factor in determining the success of your business. Investors expect your management team to understand the impact of your goals and strategies on your company as a whole. Equally important, investors want to see your company's overall projected report card and all the key assumptions used for achieving these results.

Some key indicators presented in New Tech's investment proposal that relate to overall performance are included in Table 3.6. Based on the targets presented in the table, prospective investors will determine if your management team is capable of managing this growth. By 2003, New Tech's sales revenue will have increased by 156% over 1998 while total assets and income after taxes will have shown an impressive 231% and 791% increase respectively for the same period. Is this realistic? If this was your situation, how would your team respond to this challenge? (The information used to calculate the financial ratios in Table 3.6 is drawn from New Tech's five-year projected financial statements presented in exhibits 4.1 and 4.2 of Module 4, Build an Investment Proposal). The benchmarks for a leader in this industry are listed on the right-hand side of the table.

Table 3.6 : New Tech's Corporate Goals and Benchmarks

	1999	2000	2001	2002	2003	Bench-Mark
Financial health score	2.86	3.47	4.30	5.24	5.87	n.a.
Sustainable growth (%)	10.4	22.2	39.3	39.8	36.9	n.a.
Company's growth (%)	30.0	20.51	23.4	15.5	14.9	n.a.
Economic value added ($000)	-57	244	590	747	908	n.a.
Return on total assets (%)	5.9	13.6	20.7	22.6	22.8	21.0
Return on sales (%)	5.2	11.7	18.0	20.9	23.9	17.0

Some key points that relate to this portion of your analysis include:

- For each operating function (marketing, production) describe your organizational structure.
- How is each function's structure compatible with your goals and strategies?
- How many people each year will you need to manage this growth?
- What core competencies will you need to realize these goals? Do you have them?
- What will be the future evolution of your organizational structure?
- Is your structure compatible with your corporate profile and corporate strategy? How?
- Does your structure promote co-ordination among its functional units? How?
- Describe how your structure allows for the appropriate grouping of your activities.
- Who will be responsible for the key functions? Are your job descriptions included?
- Give a description of the skills and capabilities of your key executives who will be responsible for these goals.

Marketing/Distribution Management Capabilities

The primary purpose of marketing/distribution goals is to maximize overall company sales revenue. A secondary purpose is to achieve maximum productivity from sales, promotion and distribution activities. Some key questions that relate to this portion of your analysis include the following:

- What management and business skills will you need to manage this growth with regards to sales, product development, advertising, promotion, distribution and market research?
- Who will be responsible for these different functions? Enclose their job descriptions and curriculum vitae.

Production/Operations Management Capabilities

Production/operations management involves the process of transforming inputs, such as raw materials and parts, into outputs. The prospective investor must be able to determine whether you have the capacity to produce sufficient quantities of your product to meet your sales projections. You will need to provide analyses to support your production levels and to show you are managing your production costs. Some key questions that relate to this portion of your analysis include the following:

- What management and business skills will you need to manage this growth with regards to production, production control and quality assurance, inventory management, production planning and scheduling?
- Who will be responsible for these different functions? Enclose their job descriptions and curriculum vitae.

Accounting/Finance Management Capabilities

The management skills needed to implement your financial strategies must simultaneously address the issues of liquidity and short-term solvency, asset management, debt management, overall profitability and cash flow management. Individuals working in the area of finance should have skills related to these issues. Some key questions that relate to this portion of your analysis include the following:

- What accounting and financial management skills will you need to manage this growth with regards to accounting, accounts receivable collection, accounts payable, payroll, financial controls, accounting systems, planning and budgeting?
- Who will be responsible for these different functions? Enclose their job descriptions and curriculum vitae.

R&D/Engineering Management Capabilities

Organizations with an effective R&D/engineering department are, in essence, lowering their risks by making themselves more competitive. The product and service R&D/engineering function focusses on market competitiveness, and the process R&D emphasizes cost competitiveness. Some key questions that relate to this portion of your analysis include the following:

- What R&D skills will you need to manage this growth with regards to product and process research?
- Who will be responsible for these different functions? Enclose their job descriptions and curriculum vitae.

Human Resource Management Capabilities

The prospective investor will review your human resource management capabilities. You should be able to demonstrate that you have engaged a team of people (managers and employees) who share a common goal — the success of your business. As discussed earlier, you may have to make changes in your team or realign responsibilities to optimize the skill mix. You may have to add new members to acquire additional skills. The following performance elements provide an outline of the human resource management skills you will need. Some key questions that relate to this portion of your analysis include:

- Have you made appropriate plans to ensure the continuation of your business if a key member of your management team leaves or becomes sick?
- Do the members of your management team receive large salaries, or is their compensation based on performance and results?
- Do you ask for and reward high performance? Do you have an employee share ownership plan?

> One of the keys to obtaining investment capital, from any source, is your ability to gain the trust of the prospective investor. If you give any indication that you are not completely forthright, you will cause the investor to have second thoughts about your proposal. Credibility is like honour in battle — you only lose it once.

5. Conclusion

In this module, you looked at:

- why management capabilities are important to investors;
- how to present the evolution and track record of your management team;
- how to identify your management's capabilities by matching the management skills to the needs analysis process, and using the competitive strength assessment approach; and
- how you can show that your management team will have the capability to reach your business goals and implement your strategies successfully.

In the next module, Build an Investment Proposal, you will take the final step to become investor ready. You will learn about the importance of preparing an exceptional investment proposal, the key elements of a well-documented investment proposal, the significance of an effective executive summary, the difference between a business plan and an investment proposal, and some legal and regulatory considerations that you should take into account when preparing an investment proposal.

As you go through the next module, pay particular attention to understanding the needs and expectations of your potential investors. Take a critical look at your investment proposal through the eyes of the investors you are trying to impress. This will be the final step in the becoming investor ready phase before you start into the next phase, building investor relationships.

Case Example

This case example allows you to follow a fictitious company, New Tech Distributors Corp. (New Tech), as it seeks risk capital to finance its growth. The case shows how New Tech addresses the key elements presented in the Details *section of each module.*

If you have not already done so, read about New Tech's background and the challenges it faces in the earlier modules. As well, you may wish to refer to the Steps to Growth Capital Overview for an introduction to the overall structure of this program.

Read about how New Tech examines the strengths and weaknesses of its management team. You should refer to the Details *section of this module for more information related to this subject.*

The Team

At one meeting, Grant Argent (New Tech's financial advisor) stressed the point that investors will be interested in investing in a company that is managed by a professional and skilled management team. The New Tech management team will have to demonstrate that it has the capabilities in four key functional areas: marketing, sales, finance and operations. Also, investors will be looking for specific management and business skills in product knowledge, financial management, research and development, production and human resources.

Grant points out that the management track record is very important to investors. In addition to scrutinizing New Tech's business credentials and qualifications, investors will want to learn how the company resolved earlier business and management problems. Grant also emphasizes that New Tech must present to investors the image of a strong and cohesive management team. Investors will determine whether New Tech's management team has the experience, required qualifications, skills and commitment to manage New Tech's ambitious growth objectives successfully. Grant is of the opinion that this will be a concern to potential investors. Grant indicates that highlighting weaknesses will hasten the team to take the necessary steps to strengthen the skills of each member of the management team and to provide investors with convincing evidence that New Tech is fully committed to its growth potential and objectives.

Grant is invited by Stuart Chip (New Tech's president) to carry out an assessment of the management team's capabilities. To perform this task, Grant reviews the job descriptions of all members of the management team as well as all key employees. He then proceeds to interview all of them, focussing on a variety of topics related to their functional responsibilities. His key findings are as follows.

- Elizabeth Pratt, 37, is a good accountant. She obtained a general arts degree from a local university and is now taking evening courses in accounting. Her previous employment was with a software company where she worked in the controller's department. Grant is concerned that she may not have the required skills to take New Tech to the next stage of its development. For instance, he is concerned about her lack of knowledge in the area of cost accounting; this will be important for New Tech when the new product line is launched. Other members of the management team have also commented about her lack of experience in providing them with meaningful financial reports and analysis. Grant is of the opinion that Elizabeth does not have the ability to guide the company through the initial public offering (IPO) process that could be realized (if the new product line is launched) within the next five years.

- John Harley, 55, is considered a good salesman for New Tech's current product line, most of which could be classified as commodity items. The new power modules will be made-to-order and require someone with the ability to identify customer needs and work more closely with larger, blue-chip companies. Grant feels that Harley does not have this particular background and experience. His previous positions were with smaller companies involved in selling commodity products. Harley also does not have the necessary experience in preparing a marketing plan for the new product line. A market research report on the new product line has been ordered from EconTechData, and the findings are expected to arrive next month. Harley is more sceptical than Stuart about the level of success of the new product line.

- Kevin Matley, 41, gained extensive production experience with larger companies before joining New Tech. His former employer was disappointed when he left to join New Tech. Matley has informed Grant that he is concerned about the shortage of experienced engineers required to design the new product power modules just in time for the scheduled production. He has indicated that, in today's market, it is time consuming and difficult to find qualified individuals and he is not interested in making hasty decisions just for the sake of hiring engineers.

Although Grant raised several concerns, he nevertheless identified several strengths. Stuart is highly regarded by his management team. The members of the management team are very effective and function very well together. Stuart's prior experience with a larger organization was an advantage, as he was familiar with working in an environment where a business expanded rapidly. However, the fact that Stuart has worked for only larger businesses is a concern to Grant. He feels that Stuart's lack of experience in managing a small fast-growing business would be considered a weak point in the eyes of investors.

Because there are key issues that Grant feels should be resolved before approaching investors, he decides to meet with the management team to go over some of these issues. However, he suggests meeting Stuart separately to inform him of his concerns about Elizabeth's and John's shortcomings.

Stuart indicates to Grant that he is aware of Elizabeth's limitations and that he is not prepared to replace her at this time. He points out that Elizabeth is taking a course in accounting offered by a local university. Grant stresses the point that in many instances, investors are very knowledgeable about finance and would insist that New Tech find someone with better qualifications, particularly if the company goes public.

Grant also raises his concern about John Harley's weak spots. After their discussion, Stuart indicates he will contact an executive search firm to help find a more senior salesperson to head up the computer module marketing function. He realizes that John may leave New Tech if a new person is recruited to head the marketing unit, but Stuart is of the opinion that the commodity side of the business presents enough of a challenge that the chance of John staying with New Tech is good.

Grant also meets with New Tech's solicitor as the company will need a lawyer with experience in the field of investment securities. The firm New Tech now employs, Pratt, Mat and Spatt, specializes in real estate with limited experience in preparing financing agreements. The solicitor recommends another firm to Grant.

Grant also raises the point about how investors may perceive Stuart's lack of experience in managing a small company through the various developmental stages. Stuart responds that if this is a perceived weakness, he would consider looking for an investor with extensive experience in this field.

Many options are suggested in the subsequent brainstorming sessions about how to deal with these important issues. In the area of power module development and production, the team feels the timing for introducing the new line is too ambitious. After examining several alternatives, a consensus is reached to delay the new line until the market information is received.

The staffing of several key executives has been a real concern to Grant as New Tech still needs a senior salesperson for the new line and qualified engineers. Stuart agrees to postpone contacting investors until these matters are resolved. In the meantime, Elizabeth is asked to prepare a draft of the investment proposal for review by the management team. Stuart wants the company ready to meet potential investors when these issues are resolved.

Author's Note:

New Tech is now focussing on one aspect that investors consider to be very important — management capabilities to help exploit the full potential of the company's growth opportunity. The company has:

- *learned that investors will want to see the past, present and future strength of the management team;*
- *recognized the importance of being forthright with potential investors;*
- *learned it should seriously analyse all aspects of the business; and*
- *recognized the importance of being proactive in improving areas of management weakness through upgrading the skills of existing executives, hiring new ones, using advisors and even using potential investors.*

Myths

You do not need a management team.

"I can do it myself. I don't need anyone else to help. I have a business degree, or I have taken lots of courses in this area. I can't afford a large executive payroll. It's my idea, and no one else is going to have the same commitment to its success as I do." These are common reasons for an entrepreneur to refrain from putting in place a strong management team. It is important that you attract a strong management team for several reasons. First, potential investors prefer investing in a company that has a strong management team. Second, no individual can give 100% of her/his time to all management and business functions. Third, it always helps to have someone who is knowledgeable and experienced to share the load.

My product is so good, it will sell itself.

No matter how good, exciting or technically superior your product is, not everyone will share your enthusiasm, especially investors. Your interest may not always be shared by investors. You want to make your company grow and be successful. There is no question that investors want to believe you and share your dreams; however, they want to make sure you will be able to repay their investment at the time of exit and that you have the management capabilities to make that payment a reality.

Frequently Asked Questions (FAQs)

Do I really have to provide all this information to an investor?

Yes. Investors and risk capital firms usually have a responsibility to other people who are investing behind the scenes. The more thorough you are at the outset, the more responsive and attracted potential investors will be to your product and management team.

Do I have to give up decision-making authority if I need more capital?

Not always. Investors will determine the level of involvement they will want to have in your company to ensure that it will be professionally managed and, most important, that their investment will be safeguarded. The level of involvement varies from investor to investor. They may suggest a seat on your board of directors and even ask for extensive control over your operations. The ownership question will likely occur when discussing the various forms of financial structures and instruments examined in the Identify Your Financing Needs and Identify Potential Investors modules.

Why do I have to let investors know my last business wasn't successful?

It is always better to be honest about previous situations. Investors will most likely find out about your earlier experiences anyway. If you indicate that you have learned from earlier mistakes and failures, which may or may not have been your direct responsibility, your potential investors will probably be more reassured about your management capabilities.

Why do I have to tell investors about my weaknesses? Why can't I simply concentrate on my strengths?

It is unusual for a single person to possess all the management and business skills and competencies necessary to manage every function of a business. Some individuals excel in the planning function, others have strong technical skills and some are competent in marketing. Investors need to know your strengths and weaknesses, and what steps you are considering to compensate for your weaknesses. Even if you are not able to raise funds from investors, you should pinpoint your management weaknesses in order to take the necessary steps to improve them.

Module 4: Build an Investment Proposal

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Executive Summary

You have now reached the last step to become investor ready. This module shows how you will pull together, in a logical and comprehensive whole, some of the information presented in the previous modules. The steps you have learned up to now will help you focus on a very important journey to establish a strong and fruitful relationship with potential investors by convincing them that they should invest in your company and form a partnership with your management team.

This module explains the difference between a business plan and an investment proposal. It is important to point out, at the outset, that an investment proposal is not a duplicate copy of a business plan. An investment proposal is a specialized business document aimed specifically at responding to the needs of potential investors. Once you have completed the final draft of your investment proposal, you may consider yourself "investor ready." There are two cardinal rules to remember from this module:

- If your investment proposal contains a convincing executive summary, the investor will most likely be inclined to read the details of your proposal.
- If you present a persuasive investment proposal, the chances of clinching a first meeting with potential investors are greatly enhanced.

The investment proposal is your primary contact with potential investors. It must capture their interest and address their needs quickly and effectively. They want to understand promptly the "deal" presented to them. An investor's decision to continue reading the details of your proposal and, subsequently, to invest in your business opportunity, depends largely on the physical appearance and quality of the content of your proposal.

The case example illustrates how an effective investment proposal can be presented. If you have gone through the previous modules, you should be familiar with New Tech Distributors Corp. (New Tech). This module builds on New Tech's case example presented in earlier modules to show you how the company went about preparing its investment proposal.

> An investor's decision to invest in your business venture depends largely on the physical presentation and quality of the content of your investment proposal.

The investment proposal packages information about your financing needs, your financial requirements, your investment potential and your management capabilities. This module gives you the framework, or blueprint, of an effective investment proposal, that is, one that meets the needs of your prospective investors. To get the maximum from this module, it is highly recommended (if you have not done so already) that you go through the first three modules, Identify Your Financial Needs, Demonstrate Your Investment Potential and Demonstrate Your Management Capabilities.

This module covers seven topics.

1. **The investment proposal.** What is an investment proposal? Why is the investment proposal such a critical component when approaching risk capital investors?

2. **Difference between a business plan and an investment proposal.** What are the fundamental differences between an investment proposal and a business plan? Although they are related, each document is written for a specific purpose and for different audiences.

3. **Importance of an effective investment proposal.** How do you capture the attention of your investor? How do you make a good first impression? How do you go about drafting and presenting a distinctive investment proposal that will stand out from the others?

4. **Importance of the executive summary.** How can you get your potential investor interested in reading your entire investment proposal? Investors have limited time and they want to use it wisely. Unless you capture their attention quickly with a convincing executive summary, investors will not read the details of your proposal.

5. **Key elements of an investment proposal.** What information should you include in your investment proposal? How should it be structured? The proposal should provide sufficient information about your business opportunity and your management team to allow prospective investors to make an informed decision.

6. **How to build an effective investment proposal.** How should you go about preparing and organizing your investment proposal? Are there any particular formats for presenting your document? A professional and convincing investment proposal includes the right amount of information packaged in an easy to read and understandable format.

7. **Legal and regulatory issues.** Have you considered legal and regulatory issues related to your investment proposal? Most likely, your investment proposal may be subject to certain federal and provincial securities regulations. You have to make sure your proposal complies with all regulatory bodies (federal and provincial).

Details

1. The Investment Proposal

An investment proposal can be regarded as a "ticket of admission" to the investment process or a "calling card" that introduces your company and your opportunity to prospective investors; it has to speak for the company appropriately and successfully. Without an investment proposal, risk capital investors will not even consider granting you a meeting. To get to that first meeting, your proposal must be the best that can be written and packaged. It should read easily, be packaged appropriately, focus on the key issues and, most important, be enticing enough to catch the investor's attention.

It should be noted, however, that much of the information contained in your investment proposal can be drawn from your detailed business plan. As will be seen in the next section, both documents are prepared for different audiences or users and for different purposes. The investment proposal must contain information that is tailored to a very specific purpose — to raise the capital funds required to meet your financial needs.

An investment proposal can be defined as a document prepared by management that summarizes for readers independent of the business, presumably lenders and investors, the nature of a business, its historical activities (if any), its growth potential, and its financial needs and financing requirements to realize its financial objectives and implement its strategies.

Scanning the Investment Proposal

As indicated in Module 2, Demonstrate Your Investment Potential, before signing any deal, investors will want to have four conditions included in the final agreement:

- an acceptable rate of return, that is, how much they can expect to earn from the deal;
- confidence in management, that is, a management team that has the business and management skills needed to carry the project through to a successful conclusion;
- a viable exit strategy and options to realize their investment; and
- the ability to monitor and control their investment, that is, measures that will help them protect their interest.

These critical conditions should be clearly stated in the investment proposal if you want to capture an investor's attention. Based on in-depth interviews with dozens of venture capitalists, including bankers, lawyers, accountants and consultants, almost everyone reviews investment proposals in the same way: they first take five minutes to go over the document. Less than one minute is invested in each of the following steps.[1]

Step 1: Determine the Characteristics of the Company and the Industry.

- Are we interested in this industry? In this technology?
- Is this company public or privately owned?

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[1] Joseph R. Mancuso, *How to Prepare and Present a Business Plan* (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1983), p. 14.

- Will this company be saleable?
- What were the sales revenue and profit last year?
- Where is the company located?

Step 2: Determine the Terms of the Deal.

- What percentage of the company is being sold?
- What is the price?
- How much do they want?
- What is the value of the business now?
- Are existing owners re-investing in this company today?

Step 3: Read the Balance Sheet.

While the most recent balance sheet exposes facts, and all projected balance sheets are based on hopes, investors will only look at the most recent balance sheet to get answers to the following questions:

- What is the liquidity position of this business?
- What is the debt-to-equity structure?
- What is the worth of this business?
- What are the assets (the real, tangible ones) and the liabilities (who are the lenders)?

Step 4: Determine the Calibre of the People in the Deal.

- Who are the founders, the members of the board of directors, the current investors, and the outside professionals (accountants, lawyers, bankers, consultants, directors)?
- What is their reputation?
- What is their track record?
- What is the calibre of the management team?

Step 5: Determine What is Different about This Deal.

- Is there an unusual feature in this product or service?
- Does the company have a patent, an unusual technology or significant lead over its competitors?

Step 6: Give the Plan a Quick Scan.

After reviewing the above points, the risk capital investor will take the last minute to thumb through the investment proposal to look for product literature, graphs, unusual exhibits, samples, letters of recommendation and letters of intent.

After going over the investment proposal quickly, the risk capital investor will determine whether to read more and ask for additional information, or to return the document. Once the decision about the proposal is made, it's usually all over. So, it is critical to realize that it is during the first five minutes that your investment proposal will either pass the test or be rejected.

To get the risk capital investor's attention, the investment proposal must:

- address your investor's specific information needs;
- explain how your customers will benefit from your products and services, and provide strong evidence of their marketability;
- demonstrate that your management team is experienced and has complementary management and business skills;
- contain a convincing executive summary that clearly differentiates your investment proposal from others;
- provide insight and meaningful information about how the investor will capitalize on this opportunity;
- prove that you have done your homework;
- present believable financial projections with the more important data and assumptions explained and documented;
- show how investors will be able to cash out successfully in three to seven years; and
- provide an objective analysis of your company's strengths and weaknesses, and the risks and opportunities it faces.

2. Difference Between a Business Plan and an Investment Proposal

Most businesses go through some form of a planning process in order to produce a planning document. The scope and complexity of the process depend on the nature and the status of the company. However, planning documents are done for different reasons (to plan the activities of a business or to raise money) and are aimed at different audiences (managers or investors).

As shown in Figure 4.1, the information contained in a planning document allows internal users (owners and managers) and external users (lenders and investors) to make their respective decisions. The users of the planning document determine, to a large extent, how this document will be named. If the planning document is to be used *internally* (by managers), it will be called a *business plan*. If it is to be used *externally* (by investors), it will be called an *investment proposal*.

Figure 4.1
Difference Between a Business Plan and an Investment Proposal

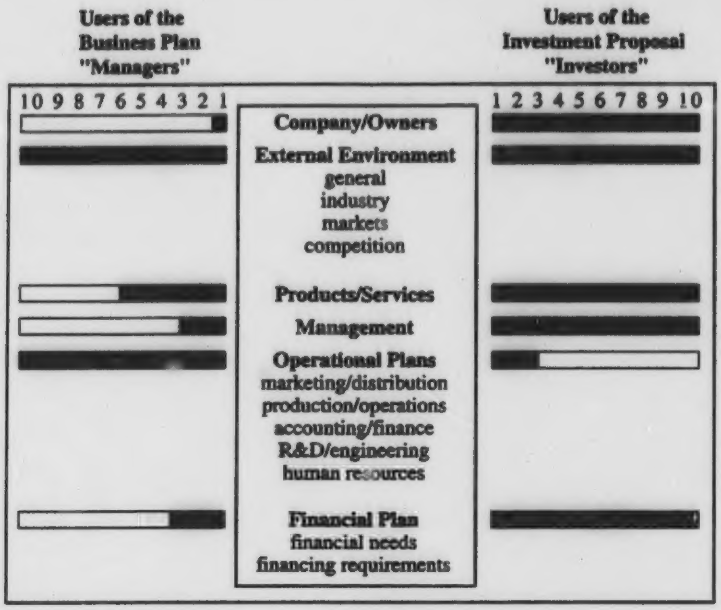
Users of the Business Plan "Managers"
Users of the Investment Proposal "Investors"
10 9 8 7 6 5 4 3 2 1
1 2 3 4 5 6 7 8 9 10
Company/Owners
External Environment
general
industry
markets
competition
Products/Services
Management
Operational Plans
marketing/distribution
production/operations
accounting/finance
R&D/engineering
human resources
Financial Plan
financial needs
financing requirements

Figure 4.1 shows the depth of information that should be included in these two planning documents. The left side of the figure shows, on a scale of 1 to 10, the amount of information that should be included in each major segment of a business plan. The right side shows the depth of information that should be contained in an investment proposal. To illustrate, it would be irrelevant to include much information in your business plan about your company and ownership structure. However, detailed information in an investment proposal would be important to lenders and investors. Let's briefly examine the differences between these two planning documents.

A *business plan* is normally used as an internal management tool to measure your company's success. It is a very comprehensive and detailed document, and has an operations, strategic and marketing focus. It provides a blueprint of how your company is going to go about implementing your plans.

As shown in the figure, the primary purpose of a business plan is to help managers co-ordinate resources and activities, particularly across functional or divisional boundaries. Upper-level management will use the information to gauge the desirability of performance for major initiatives. Divisional and functional managers will use the information to guide ongoing operational decisions, including objectives (measurement indicators) and operational plans.

The business plan gives a detailed description of the company's operational plans for each function (production, marketing, distribution, finance, etc.) in terms of who is going to do what, when, how and where. The focus of the business plan is to realize five objectives:

- clear communication of the business goals, strategies and plans;
- integration of the functional goals with strategies;
- detailed description of the process for implementation;

- contingency plans; and
- capability to translate the plan into capital and operational budgets.

The *investment proposal* is the calling card that introduces your company and your investment opportunity to prospective investors. It is tailored for the specific purpose of raising financing from outside banking and investment firms. The investment proposal can be built on the components of the business plan. As mentioned earlier, the investment proposal must focus on your investors' needs and most important, capture their attention. As shown in Figure 4.1, the investment proposal should focus on several key points that were identified in the previous section, Scanning the Investment Proposal.

3. Importance of an Effective Investment Proposal

The higher the quality of the physical appearance of and the information contained in your investment proposal, the better your chances of attracting the interest of risk capital investors. The investment proposal conveys a first impression of your company, your investment opportunity and your management team. Remember the old saying: You will never get a second chance to make a first impression.

Risk capital investors may have many investment opportunities to analyse. This can be time consuming. Your investment proposal is competing against other investment proposals for the time and funds of investors. If your proposal fails to stand out, it may be ignored, receive a lower priority or be rejected.

As indicated earlier, investors will want to look quickly at critical information to decide whether to read on. The investment proposal should look professional, preferably bound in a folder bearing the company logo. If such folders do not exist, the plan can be bound in a window folder with the name of the company and the contents on it. Use colour and graphics whenever possible to enhance the readability and appearance of the document. Appearance will help the proposal accomplish certain tasks.

- Capture the potential investor's interest. If it is properly written, structured and presented, the investment proposal will help build the prospective investor's confidence in your ability to carry out your company's strategic growth plan.
- Provide key background information about your company, your management team and growth prospects.
- Supply sufficient information and insight about your company and its growth opportunities.

For information on how to identify potential investors, refer to the Identify Potential Investors module.

For information on meeting prospective investors, refer to the Meet Potential Investors module.

Always focus on the investors' interests and needs. Include only as much information as is necessary to meet prospective investors' requirements. If you prepare an investment proposal that is too comprehensive, investors may not be willing to invest their time to read through it. Additional material can always be sent to prospective investors later.

4. Importance of the Executive Summary

The *executive summary* is two to four pages located at the front of your proposal that give an overview of the company and provide the highlights of your investment opportunity. It is primarily designed to capture the interest of prospective investors.

Your executive summary is important because it:

- may be the only segment of your investment proposal that prospective investors read;
- must capture prospective investors' attention and entice them to read the details of your proposal (you may have an excellent opportunity, but if the executive summary is vague, prospective investors may not read it); and
- may be sent to other investors or their intermediaries as a stand-alone document to introduce your investment opportunity. If this is the case, the rest of the investment proposal would be called for only if the executive summary is compelling enough to attract their attention.

An effective executive summary describes your company accurately and differentiates your business opportunity from others competing for investment capital. The final measurement of its effectiveness is whether it persuades a prospective investor to read further or to request additional information. The executive summary should highlight what differentiates your company and its products and services from other investment opportunities. It should contain:

- a brief description of your company's structure and its major players;
- a brief description of your company's purpose in the marketplace, including an outline of your products and services, the markets you serve, and the key factors that affect your operation and success;
- a brief description of your management team;
- a summary of your financial needs and financing requirements, including the amount, the timing and the proposed structure or financing instruments;
- potential exit strategies available for your investors; and
- a summary of your key financial results, both historical (two years) and projected (three to five years).

For more information on demonstrating your investment potential, refer to the Demonstrate Your Investment Potential module.

After you have drafted your executive summary, you should obtain some comments and input from your advisors (accountants, lawyers, other experienced intermediaries as well as other contacts who have successfully raised financing). Outside sources can provide valuable input as to whether the executive summary is effective and, if not, suggest how it can be improved.

5. Key Elements of an Investment Proposal

There are no perfect sequences for the contents of an investment proposal. Each reader may want to see sections in a different order or see different information emphasized. Also, the length of the investment proposal depends on your product, the stage of development of your business (start-up versus ongoing) and the amount of funds you are seeking.

A typical table of contents for an investment proposal would include:

Contents

Executive Summary
Company and Ownership
External Environment
Products and Services
Management Team
Operations
    Marketing/Distribution Plan
    Production/Operations Plan
    Internal Accounting Plan
    R&D/Engineering Plan
    Human Resources Plan
Financial Plan
    Financial Needs
    Financing Requirements
Appendixes

In addition to the suggested content, certain requirements, disclosures or restrictions that are governed by securities legislation may also exist (depending on the province in which your company is located). Before drafting the investment proposal, legal advice should be sought to ensure you are in compliance with all relevant legislation and regulations. For further information on regulatory issues and securities legislation, refer to the Legal and Regulatory Issues section of this module.

You can refer to Figure 4.1 on page 6, to determine the level of detail that should be included in your investment proposal.

Note: This section does not presume that you have completed a business plan. However, if you have, the preparation of your investment proposal is made easier since much of the information can likely be pulled from the business plan document.

Executive Summary

As discussed earlier, your executive summary presents an overview of the company and the highlights of the investment proposal. It should focus, in a concise and persuasive manner, on six key elements:

- a description of your company's structure and its major players;
- a description of your company's purpose in the marketplace and its products and services;
- a description of your management team;
- a summary of your financial needs and financing requirements, including amount, timing, proposed structure or financing instruments;
- potential exit strategies available; and
- a summary of key financial results, both historical (two years) and projected (three to five years).

Charts, graphs and tables should be used in the investment proposal and especially in the executive summary section. They can effectively display large volumes of information.

Company and Ownership

Prospective investors need to evaluate where your business has been in order to gauge the feasibility of realizing the objectives and strategies presented in your investment proposal. The content of this section may include:

- a chronological history based on major milestones (when the business was founded, key product introductions and successes, financial milestones — break-even point, sales levels, history of investments, etc.);
- its form of ownership (public or private company, date of incorporation);
- the names and addresses of founding shareholders and directors;
- for a public company, the details (authorized, issued and issue price);
- a copy of letters of patent or corporate charter and by-laws; and
- the company's major successes or achievements in the field to date.

The milestones could be discussed in paragraphs or summarized in chart form as follows.

Year	Description of Event	Comments

The history of your company should be connected to the current need for financing. For example:

- If the past history of your business is not a strong indicator of future performance (because of management changes, or product or service changes), this should be mentioned in the history section and reinforced in other sections of the investment proposal.
- If the growth opportunity involves the launching of a new product or expansion into new markets, this should be clearly spelled out in the investment proposal.

External Environment

Your prospective investor is relying on the investment proposal for a better understanding of the company's industry, markets and competitive environment. This essential background information helps your investor decide whether the company can successfully implement and achieve its strategic plans to capitalize on the growth opportunity identified in the proposal.

Both managers and potential investors must understand the structure of the company's operating environment since the success of your company is determined, in large measure, by your ability to respond effectively to external forces in terms of opportunities and threats. The external assessment provides background information for both the business plan and investment proposal, specifically by placing the company's goals and strategies in perspective with the activities and relationships that your company can influence, but not control.

For a discussion of the external environment, refer to Module 2, Demonstrate Your Investment Potential, under the section How to Demonstrate Your Potential for Growth. As mentioned in that module, the four key components for analysing the external environment should include:

- general environment;
- industry characteristics;
- market dynamics; and
- competitive climate.

When presenting industry, market or competitor data (either historic or projected), the opinion of a third party would add credibility to your sales estimates. There are numerous sources for this type of data, including government, industry publications and private research studies. Providing third-party data gives the investor additional confidence in your conclusions.

Products and Services

Describe the products and services your company currently provides as well as those you plan to offer. You need to tell your prospective investor what business your company is in and how the products and services are going to be marketed. The following information should be provided:

- Describe current products and services (and their key attributes) and outline marketing, customer service and distribution strategies for these products and services. Similar comments should also be included for any new products or services you are planning to market. Where possible, compare and contrast your products and services with those of your competitors.
- Also important, is a description of the features of your products/services in terms of how they differentiate from your competitors. When describing your product and service, emphasize the characteristics that distinguish them from others in the marketplace (its low cost, versatility, higher quality, patent protection, etc.). The prospective investor will want to know your distinct competitive advantages at the outset.
- Where applicable, describe your company's new product development process.

The length of this section depends on the number and complexity of your products and services. The language should be simple enough to be clearly understood by anyone not familiar with your business. Remember, you may have detailed and technical knowledge of your products but prospective investors may not be as technically knowledgeable. You must be able to describe your products and services on a level they understand.

Consider the use of charts and tables to describe your product or service attributes and to present comparisons with competing products or services. You may provide only a synopsis of your product in this section with additional detailed information, if necessary, in the appendixes. This gives prospective investors the option of finding out as much information as they require. Also, detailed technical information could be held back until later in the negotiation process — usually after the initial meeting — particularly if you want to protect the proprietary aspects of your product.

Management Team

Risk capital investors want to learn as much as possible about the members of the management team who will be managing the business they will be investing in. As mentioned in an earlier module, venture capitalists say they prefer a grade A entrepreneur (jockey) to a grade B entrepreneur with a grade A idea (product or service). The significance of this is that investors put a higher priority on the management team than on products and services.

They want to deal with a diversified management team with management abilities and business skills that will contribute to the success of your business venture. For a complete discussion of management, refer to Module 3, Demonstrate Your Management Capabilities.

This section of the investment proposal must emphasize the experience and competence of each key member of your management team. The following information should be included:

- Describe the experience and skills of key members of your management team. Include a short biography on each person, and provide résumés to be included in an appendix.
- Describe weaknesses in your management team (if any), and how these deficiencies will be dealt with. In some instances, a prospective investor will want to provide management expertise in a particular function, as well as cash.
- Provide an organizational chart showing the key members of your management team and employees by functional area and responsibility.
- Provide information on key employees, particularly those instrumental to your business such as skilled production labour, supervisors, plant managers and designers.
- Give some general information as to the number of employees and labour requirements of the business. This information may include the number of hourly versus salaried employees, average hourly wage rates, fringe benefits, number of employees by functional areas, existence of a union, history of labour relations, etc. (as with other sections, general information could be included in the body of the document with additional detail provided in an appendix).
- Describe key management practices and the employee benefit package, if applicable.

Operations

As shown in Figure 4.1 on page 6, there is a significant difference in the type and depth of information that managers and investors want to look at in terms of operational activities. The business plan will include detailed operational objectives and plans for each function (i.e. marketing, production). For example, it would include a detailed description of your advertising program with information on the advertisement itself (i.e. the content of the ad), when the advertisement would appear (i.e. which week), and what media it would appear in (i.e. radio or newspaper), as well as the detailed cost.

Investors are not interested in this level of detail. Instead, they will want to see in your investment proposal the more important goals and strategies that you intend to implement for each function, and how they will be integrated to provide a clear focus for your company. The sections dealing with each function must be tailored to meet the specific needs of the intended user (investor). This information may be presented in several ways, such as a brief description for each function, or tables including strategic goals for each functional area, the strategic plans to be implemented, as well as the resources required to implement them.

For each operating function, your investment proposal may focus on:

- an overview of the rationale for your strategic plan (a description of the growth opportunity and why the company feels it can capitalize on the opportunity);
- a description of the more important actions you will take to implement the strategic plan; and
- the impact of these actions on your current marketing, production, financing and human resource functions.

Here is a brief description of the type of information that could be included in the investment proposal for each major function.

Marketing/distribution plan

After you have defined your industry, markets and competitors (see Figure 2.1 in Module 2, Demonstrate Your Investment Potential), investors will want to know how your marketing goals and strategies will be realized including answers to the following:

- What is your product strategy?
- What is your pricing strategy?
- What is your distribution strategy?
- What is your promotional strategy?
- What sales revenue will you realize for each product or service? For each geographic market? By customer segment? By channels of distribution?
- What market share do you expect to capture over the planning period?
- Will new markets be created as a result of your strategic growth plan?
- Will your customers be drawn from an expansion of the overall market or taken from competitors identified above?
- How are your competitors expected to react to your entry or expansion into the market or market segment? How will you respond to them?
- Will new competitors be drawn into the market as a result of your entry? How will you react to them?

Production/operations plan

Investors will want to know your production/operations goals and strategies, with emphasis on your manufacturing operations and production processes (where applicable). Summarize the nature, extent and quality of manufacturing facilities, and comment on:

- distribution systems;
- education and training requirements of employees;
- patented processes;
- state of technology (level of technology being used);
- type of equipment used;
- plant capacity;
- key suppliers and availability of raw materials;
- skilled labour requirements;
- occupancy arrangements (i.e. leased or owned premises);
- key strengths; and
- production limitations (and how these may be solved).

This material may be summarized in the body of your proposal, with detailed information, such as floor plans, photographs and flowcharts, in the appendix.

Internal accounting plan

As shown in Figure 4.1 on page 6, there are two types of plans that can be presented in planning documents: one that is used internally by managers (left side of Figure 4.1) and one that is of interest to your investors (right side of Figure 4.1). Both plans are used for different reasons.

The financial plan included in your business plan would show the financial goals expected from each division resulting from the implementation of the operational plans. The emphasis is not on financial needs and financing requirements, which are of interest to your investors, but more on the information that would be relevant for your managers. This financial plan would contain operating (sales and expenses) budgets for various branches and divisions.

These detailed budgets have little value to investors but are important to managers for control purposes. The information contained in these budgets would be used to prepare the projected financial statements to be included in the investment proposal.

R&D/engineering plan

When appropriate and applicable, the research and development (R&D)/engineering plan identifies specific goals and strategies for the period covered during the planning period, and the assignment of responsibilities for R&D activities. A description of the R&D/engineering plan should include the following:

- Outline where your R&D efforts are being focussed, that is, whether the thrust is new product development, improved product quality, increased production output or reduced productions costs.
- Provide information on the background and skills of your key players in the R&D function, describe your R&D facilities and identify the person who is responsible.
- Describe the decision-making process within your R&D, e.g., when a new product is ready to be marketed or when cost-saving technology is ready to be introduced to the production facility.

Human resources plan

This plan should consider whether or not the required categories of labour (skilled, semiskilled, unskilled) are available. The plan should clearly demonstrate that, at the start of production, every important technical position will be filled by a worker with the level of skill required. This plan should include:

- personnel required (by function) with organizational chart;
- number and category of workers required;
- training needs and costs;
- compensation program (fringe benefits, health insurance, paid holidays, accident insurance);
- working conditions;
- turnover and morale;
- company's labour relations policies; and
- identification of new positions that may be required as the company grows and diversifies.

Financial Plan

The financial plan is the most referred to and, therefore, the most important part of an investment proposal. It is often the first element of the business plan that investors look at.

This section includes historical financial results of your company, including a summary of your income statements, balance sheets and cash flow. It is useful to provide a brief management commentary (one to two paragraphs) for each year presented. The commentary should explain major year-over-year fluctuations for key financial segments (sales, gross margin, operating income, working capital, debt, etc.). This provides potential investors with some perspective and background information on the financial results you have achieved over the past years. Any inconsistencies between your past performance and future ability to carry out the strategic plan should be explained.

Financial needs

Projected financial statements show the impact of your strategic goals and plans on your financial performance. Prospective investors will want to assess the return expected on your new venture; projected financial statements provide this information. Your financial statements should include income statements, balance sheets and the cash flow statements for the next five years (two years on a monthly basis and three years on a yearly basis).

In addition to providing projected financial statements, it is also appropriate to comment on the assumptions you are using to prepare your financial projections for the most important items presented on your income statements and balance sheets. These could include:

- sales estimates in units;
- prices for each product;
- expenses related to cost of goods sold;
- selling expenses;
- administrative expenses;
- capital expenditures (amount and timing);
- inventory level;
- accounts receivable and accounts payable; and
- interest rates.

In addition to assessing the potential return on the investment, your prospective investor needs to see how much cash your business venture requires and when that cash is required. The forecasts included in your investment proposal must be realistic; otherwise they may generate a certain level of scepticism on the part of your potential investor. Any deviations from industry norms should be explained and supported with reasonable assumptions.

It should also be noted that the financial forecasts may be used as benchmarks for agreements in the negotiation stage. As such, you may be required to stand by them. For more details on negotiating agreements, refer to the Negotiate the Deal module.

Although not required, you might consider inserting a document that shows the results of a sensitivity analysis of your forecasts. Prospective investors will likely perform their own analysis as well; however, this can provide them with a level of confidence in your proposal because you have considered these effects when presenting your forecasts. Refer to Exhibit 1.8 in Module 1, Identify Your Financial Needs, for an example of a sensitivity analysis.

The financial forecasts in your investment proposal may be subject to securities regulations. These are covered in future-oriented information (FOFI) in securities offering documents. It would be advisable to review this portion with a legal advisor to ensure that you are in compliance with federal and provincial regulations.

Financing requirements

This section of the proposal outlines the amount of financing required based on:

- the use of proceeds from financing, i.e., what is being funded (covered in some detail in the Identify Your Financial Needs module); and
- the company's preferred financial structure (i.e. amount of debt versus equity) and requested terms (flexibility in payment, exit strategy, etc.). This was also covered in some detail in the Identify Your Financial Needs module and in the Demonstrate Your Investment Potential module.

> When summarizing your financing requirements, do not ask for the exact amount required, ask for slightly more (a cushion) to cover short-term deviations from expected results. Be realistic and be prepared for the unexpected.

There are advantages and disadvantages to covering the financing structure and to disclosing your valuation/pricing in your investment proposal. The proposed financial structure may affect the number of potential investors who respond favourably to your investment opportunity. It could also affect the final pricing, deal structure and valuation received, and may have significant tax implications.

By including a range of value or pricing, investors can determine whether your requirements and what they consider fair market value are in the same range. This can save time for both you and your potential investor. However, it discourages those investors who do not share your views on the value of your investment opportunity, particularly if you've used a price range that is too high due to unrealistic expectations or a change in the marketplace. Conversely, understating the value or expected pricing of your investment opportunity may provide a weaker bargaining position during the negotiation process. Regardless of whether you provide a range of value or pricing in your investment proposal, your valuation and pricing expectations must be realistic and defensible.

Before including your range of value or pricing, you should ensure that the form and content of your investment proposal is consistent with relevant legal and securities regulations. Be careful! Some forms specifically include pricing considerations; others require exclusion.

For more information on these concepts, refer to the Demonstrate Your Investment Potential, Identify Potential Investors and Negotiate the Deal modules.

Appendixes

Supporting documents should be included as appendixes at the end of your investment proposal. This information may include, but is not limited to:

- financial statements;

- results of market research studies;
- corporate or product brochures;
- management résumés;
- summaries of key agreements;
- letters of patents; and
- plant layout and production process information.

The use of appendixes is an effective way to present a comprehensive document, without cluttering the main body of the document.

6. How to Build an Effective Investment Proposal

Preparing an effective investment proposal is an interactive, multidisciplinary process. Team effort is an absolute must for such a significant undertaking. The creativity of each functional area in your business must be tapped, because the technical knowledge usually resides within the functions, including product development, marketing and production.

It is understood that each company should create a planning process that meets its specific needs and circumstances; however, a consistent set of iterative steps should generally be followed. The following describes one planning sequence that could be used for preparing and organizing your investment proposal.

Organize the planning process. Someone in your organization should first identify the parties to be involved, outline the basic scope of the planning process and decide on the time frame for its completion. Where resources permit, divide the investment proposal into sections and assign the work to different members of the management team. One person should be responsible for editing and making sure that the proposal is presented in a logical and cohesive format.

Obtain feedback from independent advisors. Involve outside advisors to review and comment on your investment proposal. These reviewers could play the role of prospective investors to ensure that your document meets their needs. The involvement of outside advisors (e.g. lawyers, accountants, other financial advisors, contacts who have successfully raised financing) can be helpful, as they can provide specific input regarding:

- the impact of the disclosure of certain items in the investment proposal and legal compliance with applicable provincial securities legislation;
- the financial projections included in the investment proposal; and
- the presentation of information and readability of the investment proposal.

Ensure confidentiality when preparing your investment proposal. The product description, market and financial information would be very useful to your competitors, saving many hours and thousands of dollars required for gathering the same information. Your treatment and handling of the proposal should reflect its value to you and to your competitors.

- You will want prospective investors and anyone else advising you on the investment proposal to treat it in a confidential manner. Indicate on the cover of your investment proposal "confidential" and account for each copy in circulation.

- Consider having each party receiving a copy of your investment proposal sign a confidentiality agreement. This agreement would:
    - prohibit the individual reviewing your investment proposal from disclosing the information contained in the document to other parties not covered by the confidentiality agreement;
    - protect your company if your investment proposal contains sensitive information that is vital to prospective investors but that, if divulged to others, could hinder your company; and
    - be drafted by a lawyer to ensure it is consistent with applicable provincial and federal statutes and regulations.

Pay attention to the physical form of the investment proposal. In addition to the content of your investment proposal, you should make every effort to convey a professional image of your company. This can be done by presenting an investment proposal that has a professional look. The organization and clarity of your proposal will assure capital investors of your ability to think, plan, organize and communicate your ideas.

The following are suggestions about how your investment proposal should be presented:

- Use a clear, legible font. Use letter quality print rather than dot matrix.
- Make sure your company name, or founder's name, and address are on the proposal.
- Write the executive summary and prepare a table of contents. Insert an index/tab for each section of the investment proposal for easy reference. Make sure all major topics, figures, charts and exhibits are properly identified in the table of contents.
- Use charts, graphs, diagrams and other visual aids to add interest to the document and to improve comprehension of the information.
- Package the plan in a loose-leaf binder or spiral-bound binder to facilitate revisions of certain sections. Also, indicate the dates on all revisions to ensure that you are always dealing with the most recent version.
- Ensure that there are no spelling, grammar or math errors in the document.
- The investment proposal should be written in a persuasive tone and in a writing style that is suited to the level of understanding of your audience. This is critical, particularly as it relates to technical sections.
- Insert a glossary of terms at the end of the investment proposal. The glossary will be useful, particularly if the information you are presenting is of a technical nature.
- Appendixes should be reproduced, bound and covered in the same manner as the body of the investment plan.

7. Legal and Regulatory Issues

When you seek debt or equity financing, you may be subject to certain legal and regulatory requirements that may govern, among other things, the nature, format and content of your investment proposal.

> Before contacting prospective investors, seek legal advice to ensure you are in compliance with all the legal and regulatory requirements that may affect you in raising financing.

Securities Regulation in Canada

In Canada, securities regulation is governed by provincial jurisdiction. Each province has legislation pertaining to securities-related matters. You will need to determine how your province's specific securities legislation affects your financing proposal. For this purpose, you may consider seeking independent legal advice. For instance, in Ontario, you may be exempted from providing a prospectus. This exemption comes under the seed capital exemption or private placement exemption of the *Ontario Securities Act*.

Provincial Securities Commissions

Securities legislation is administered by the authority designated in the applicable securities act. The jurisdictions of Alberta, British Columbia, Manitoba, Nova Scotia, Ontario, Quebec and Saskatchewan have securities commissions. A designated official administers the acts in the remaining provinces.

8. Conclusion

You have now completed the last step to become investor ready. This module examined:

- the importance and key elements of an effective investment proposal;
- the difference between a business plan and an investment proposal;
- the importance and use of an executive summary;
- the key elements of an investment proposal; and
- ways to deal with legal and regulatory considerations.

In the next four modules, you will learn how to build investor relationships by identifying potential investors, meeting investors, and negotiating and closing a deal. Most of your homework should now be completed, and it is now time to focus on the people side of financing.

As mentioned previously, as you go through the next four modules, pay particular attention to understanding the needs and expectations of your potential investors. Once again, as you proceed through these modules, try to look at yourself and your company critically through the eyes of your potential investors.

Case Example

This case example allows you to follow a fictitious company, New Tech Distributors Corp. (New Tech), as it seeks risk capital to finance its growth. The case shows how New Tech addresses the key elements presented in the Details *section of each module.*

If you have not already done so, read about New Tech's background and the challenges it faces in the earlier modules. As well, you may wish to refer to the Steps to Growth Capital Overview for an introduction to the overall structure of this program.

In modules 1, 2 and 3, we established how New Tech went through the process of demonstrating its financial needs and financing requirements, evidence of its growth potential, and the strengths and weaknesses of its management team. This information will now be used to develop New Tech's investment proposal. Read about the steps Elizabeth Pratt (New Tech's accountant) follows to develop the draft of the investment proposal.

The Proposal

It is now time to prepare New Tech's investment proposal. Elizabeth Pratt is pleased by the prospect of preparing the first draft. For some time, she has been dutifully assembling information.

Elizabeth has read extensively about how to organize and write an investment proposal, accessing various sources including business reference books and some Internet sites. She has learned that the first and most crucial part of the investment proposal is the executive summary. She knows that this will differentiate her investment proposal from others seeking funds from risk capital investors.

She also knows that the first impression made to investors is important. The executive summary has to be concise and has to capture investor interest.

She schedules a meeting with New Tech's lawyer, Tony Lee of Smith & Smith, to discuss which security act provisions the company may be subject to, the prospectus exemptions the company may qualify under, as well as any other considerations regarding the presentation format of the document.

Throughout this case, there is mention of exhibits 4.1 to 4.4.

This following proposal is fictitious. It is not based on factual research. All sections only serve to illustrate the type of information that should be presented in an investment proposal.

The following is the first draft of New Tech's executive summary. Asides to the reader are noted in square brackets[ ]. These would not normally appear in the executive summary.

New Tech Distributors Corp.

EXECUTIVE SUMMARY OF INVESTMENT PROPOSAL

Introduction

New Tech Distributors Corp. (through its QuickParts line) is a highly successful distributor of computer components and manufacturer of custom computer power modules. Since its formation in 1991, New Tech's sales have grown from $470,000 to $3 million, an average of 30% per year. The computer component business has been profitable since the second year and has given the company an opportunity to enter into a higher margin and value added lines of business.

New Tech's first expansion into value added lines was in the production of its PowerSelect custom power modules for specialized lightweight computer applications. The company is focussing the power module business on the production of custom-designed, compact power modules for high-end laptops used in scientific field work. New Tech's power module is lightweight and compact, and remains reliable despite exposure to extreme temperature swings. It can be incorporated into the body of a portable device, thereby avoiding the need for an external transformer. Finally, it speeds up battery recharge by 33%.

Field scientists, such as exploration geologists, need a laptop that can stand up to the rigours of the field, including extreme weather conditions and rough handling. They also require a compact and lightweight unit. Since the heaviest piece of equipment in a computer is the power module, a lightweight power module means a lightweight machine. An external transformer is also a severe drawback. Although scientists typically rely on battery power while taking notes in the field, when they return to the office, they plug in the laptop to use it and to recharge it.

In 1998, New Tech's QuickParts components distribution service represented 80% of its $3 million revenue, with the remaining 20% derived from PowerSelect power modules. Margins in the distribution business are at 55%, while margins for power modules are at 70%. The outlook for custom power modules used in high-end laptops is strong, according to New Tech's own market intelligence and a third-party market analysis by Market Strategy Partners. By contrast, the components market is a price-driven, commodity business.

While the components market is expected to remain healthy in the next five years — providing New Tech with continuing stable profits — long-term prospects for this business show signs of weakening according to leading forecasters. Therefore, New Tech's goal is to increase the custom power module business from 20% to 65% of its revenues during the next five years. To reflect the new strategic orientation, the company is changing its name to New Tech Special Systems Corporation.

New Tech's Products and Performance

New Tech's current product line includes QuickParts and PowerSelect.

QuickParts is a computer component distribution service offering next-day delivery largely to companies in the western Canadian provinces. Some inroads have been made into the rest of Canada and the states immediately south of the Canadian border. This portion of business has accounted for much of the past success but is not the principal focus for the future.

PowerSelect is a line of custom-designed, compact computer power modules for high-end laptops used by engineers and scientists. These power modules also have applications in specialized, portable computing equipment such as global positioning systems. The growth prospects are very good in these markets, and New Tech intends to place increasing emphasis in this area of business.

In the eight years since its inception, sales for these products have grown sixfold, from $470,000 in 1991 to $3 million in 1998. The most rapid growth occurred in 1997 and 1998, with the introduction of the initial PowerSelect power modules for a speciality application requested by an engineering firm. Sales in 1998 were almost double those in 1996.

Between 1993 and 1996, gross margins in the QuickParts business declined from 65% to 57%, but due to consistent growth in sales and careful management of expenses, the company has been profitable in every year since 1992. The introduction of the initial PowerSelect products in 1997 improved gross margins considerably, and New Tech achieved retained earnings of $654,000 by the end of 1998. Because of the higher margins available, PowerSelect provides an excellent market for New Tech's expansion.

New Tech's Target Market

The principal target market for the PowerSelect line of computer power modules is a small group of firms manufacturing specialized high-end "Lear jet" laptops and portable computing devices. These power modules are used in applications where select buyers will pay a premium for a lightweight, compact, powerful, rugged machine, such as for scientific and engineering field work, and portable global positioning systems.

The overall laptop market is experiencing very robust growth with a good outlook for the future. Much of this growth is in the mainstream segment of the market, including mid-priced machines used in general business computing.

The focus is on scientific machines used in rugged field applications, which is also seeing a strong growth. The target is a small group of specialty manufacturers of lightweight, ruggedized laptop computers used in scientific field work. There is also a market for these modules in high-end, portable global positioning system units. These manufacturers value quick turnaround times on short runs of customized power modules. Customers for the final equipment include exploration companies operating in remote locations all over the world. The selling price for these machines is in the $9,000 to $15,000 range.

Due to the high price of this equipment, it represents a small portion of the overall laptop market — large enough to provide New Tech with a good market opportunity but not so large as to attract large component manufacturers. One of the main requirements at the high end of the market is a compact power module configured to be built inside the body of the machine itself.

According to research by Market Strategy Partners, an industry analyst, the North American market for laptops has been growing at 16% per annum over the last five years and, over the last three years, the market for high-end laptops has been growing at 20% per annum. Overall sales of high-end units reached 500,000 in 1998. A power module for one of these units sells for an average price of $650. Therefore, the total size of the North American market for power modules for high-end laptops is about $325 million. New Tech's initial target market represents about 20% of this total, or about $65 million.

In 1999, New Tech projects PowerSelect sales of approximately 1,500 units, producing $1 million in revenues. By 2003, it conservatively expects sales to grow to at least 7,800 power module units per annum, or $5.2 million in revenues. Revenues could exceed this level by several times if the company can leverage its position in this specialized segment of the market to the broader laptop manufacturing market.

The Investment Opportunity

New Tech is now well positioned to take advantage of opportunities in the custom power module market and is seeking $600,000 in equity to launch a $1,575,000 venture. This financing package will be used to build a new production line for $1,100,000, to develop a new marketing program for $225,000, to increase its working capital by $200,000 and to provide a $50,000 cushion. [See the Case Example in Module 1 for details.]

New Tech conservatively forecasts increases in revenues averaging 20% a year for the next five years, reaching $7.7 million by 2003. This is based on focussing on the market for power modules used in specialized scientific laptops. Annual earnings before interest and taxes are projected to reach $2,505,000 in five years, yielding an after-tax book profit in the amount of $1,818,000 in the fifth year. Retained earnings are projected to reach $5.2 million by the end of 2003. [New Tech's five-year income statements, balance sheets and statement of changes in financial position are presented in exhibits 4.1 to 4.3 respectively.]

[Elizabeth also realizes that potential investors will want to look at New Tech's financial position in terms of liquidity, leverage, productivity of assets and profitability. For this reason, she prepared a list of financial ratios that will be included in the investment proposal. These financial ratios are presented in Exhibit 4.4.]

New Tech's Financial Performance by Product

New Tech's sales revenue is expected to increase by over 150% between 1998 and 2003.

($000)	Actual 1998	Forecast 1999	Forecast 2000	Forecast 2001	Forecast 2002	Forecast 2003
QuickParts	2,400	3,000	3,200	3,100	2,800	2,500
PowerSelect	600	900	1,500	2,700	3,900	5,200
Total sales	**3,000**	**3,900**	**4,700**	**5,800**	**6,700**	**7,700**

The company's gross margin will increase from 61% as a percent of sales revenue to 70%.

	Actual 1998 %	**Forecast 1999 %**	**Forecast 2000 %**	**Forecast 2001 %**	**Forecast 2002 %**	**Forecast 2003 %**
QuickParts	57	55	55	53	55	53
PowerSelect	71	71	71	71	71	71
Gross margins %	**61**	**62**	**65**	**68**	**60**	**70**

Operating income will also show a substantial increase, from $1,815,000 to $5,425,000.

($)	**Actual 1998**	**Forecast 1999**	**Forecast 2000**	**Forecast 2001**	**Forecast 2002**	**Forecast 2003**
QuickParts	900,000	1,100,000	1,150,000	950,000	1,000,000	900,000
PowerSelect	915,000	1,335,000	1,925,000	2,995,000	3,652,000	4,525,000
Gross margins	**1,815,000**	**2,435,000**	**3,075,000**	**3,945,000**	**4,652,000**	**5,425,000**

Income after taxes will show similar increments, from $403,000 to $2,505,000.

($)	**Actual 1998**	**Forecast 1999**	**Forecast 2000**	**Forecast 2001**	**Forecast 2002**	**Forecast 2003**
Income after taxes	403,000	425,000	900,000	1,745,000	2,287,000	2,505,000

To secure a strong niche in the specialized scientific market, New Tech plans to position itself for a strategic acquisition by a larger company within the next five to seven years. If successful in expanding the market to include a broader range of applications in the lightweight computing market, New Tech revenues could grow substantially above the levels comfortably forecast today. If revenues increase at such a substantial level, New Tech may be in a position to undertake an initial public offering (IPO) on a Canadian exchange or NASDAQ within five years.

An investment in New Tech provides an attractive combination of minimum downside, and significant upside, potential.

The book value of the company is estimated to be around $6.0 million by 2003. [See Exhibit 4.2 under the line, Total Owners' Equity.] However, the market value of the company is estimated to be in the order of $10,464,000, based on the company's after-tax cash flow of $1,308,000 with an 8X multiple factor. With a 40% share value, the risk capital investor's value of the company is expected to be around $4,186,000. [See Exhibit 2.7 in Module 2 for the details of this calculation.]

New Tech is seeking an investor who can add value to the growth process and provide full board participation. New Tech is prepared to offer a substantial minority interest (40%) in the company's common shares in return for an equity investment of $600,000, which remains to be negotiated. Given the cash flow that New Tech expects to generate, management is in a position to consider various scenarios for earnings. Management can also consider the possibility of converting investor equity into subordinated debt.

New Tech's Management Team

To ensure New Tech's success, a strong management team has been assembled, and is expected to transform the company into a more innovative, higher value added business. The management team that has been responsible for success to date is also to be maintained. However, new members, with specific qualifications required to manage the substantial growth rate effectively over the next five years, have been added. The following gives a brief profile of each member of the newly assembled management team.

Stuart Chip, President and CEO. Stuart was a project leader at Miltron Engineering for five years in the early 1980s, and a senior product manager for Digimoti Electronics for six years, before founding New Tech in 1991. He earned a master's degree in engineering from McGill University in 1980.

John Harley, Sales Manager. A technical sales specialist for 35 years, John has worked for a transmission equipment manufacturer, J.L. Praeger Industries, Vancouver; Newton Mechanics, a machine tool manufacturer north of Seattle; and People Developers, a Seattle management training firm.

Kevin Matley, Production Manager. Kevin worked in the production design for General Technical Corporation and as production manager for Crawley Tool. He has experience with implementing ISO 9000 and total quality management systems. Kevin graduated from the Technical University of Nova Scotia in 1980 with a bachelor's degree in industrial engineering.

Elizabeth Pratt, Controller. Before joining New Tech, Elizabeth worked in the accounting department of several small to medium-sized firms for 15 years, including Soft House and Technotrol Software.

Allison Muntner, CA, Candidate for Chief Financial Officer. Allison was an accountant at Hocus Pocus, a leader in the development of computer games at the time it went public. She was also a project leader with Small Business Strategies Group in Vancouver. Allison is a CA and obtained an MBA from the University of Western Ontario in 1990.

Leslie Moore, Candidate for Marketing Director. From 1988 to 1993, Leslie worked in positions with increasing responsibility in marketing for Modern Medical Office Solutions (MMOS), a designer/builder of medical facilities, and became marketing director when MMOS was acquired by Woodbury Modular Systems. Leslie graduated with a BA in marketing in 1986 from the University of Toronto and received an MBA from the same institution in 1988.

Isao Nakamura, Chief Engineer. Isao spent his entire career at Digimoti in its Japanese research and development labs, where he has been responsible for numerous successful new product designs. In 1990, he won an award from a major industrial magazine in Japan for his design of a power module for laptop computers. He is a graduate of Tokyo University, with a master's degree from the University of Southern California.

New Tech intends to recruit new members with experience related to the PowerSelect product line, and to transform this advisory committee into a formal board of directors. The board will also include representation from the new risk capital investors.

[END OF EXECUTIVE SUMMARY]

To finalize the investment proposal, Elizabeth prepares a table of contents and an outline listing the material to be included in the document. She then calls a meeting of the management team to allocate responsibility for preparing each section of the investment proposal. Grant decides to take the editing role, and within three weeks the document is almost complete.

Author's Note:

New Tech has now reached the point of preparing its investment proposal. This is perhaps the single most important step in reaching the goal of obtaining growth capital. Once again, New Tech realizes that it has done its homework well if:

- *its proposal is not a photocopy of its business plan, but a specialized document aimed specifically at the needs of potential investors;*
- *the proposal contains a convincing executive summary, increasing the chance that investors will read the investment proposal;*
- *the proposal is convincing enough to get that important first meeting with potential investors;*
- *the proposal is tailored and does not fit a template from another company;*
- *someone talks to a legal counsel to investigate legal and regulatory issues; and, most important,*
- *it realizes that to put its best foot forward to potential investors, the investment proposal will take time and effort from several key members of the management team.*

Myths

The more technical I make my investment proposal, the more confidence the prospective investor will have in my knowledge and abilities.

On the contrary, the more technical an investment proposal becomes, the more difficult it is to understand. If the investment proposal is too technical, there is a strong chance it may be disregarded by your prospective investor. The investment proposal should be clearly and concisely written to enable your prospective investor to understand its contents. If you have to include technical terms and concepts, your investment proposal must include a glossary at the end of the document.

The forecasts used in the investment proposal should be the most aggressive as this is more likely to entice the prospective investor to consider my investment opportunity.

The forecasts included in your investment proposal should be realistic. If they are too optimistic, your potential investor will most likely be sceptical about its contents. If your projections are unrealistic, the more sophisticated prospective investor will hesitate from investing in your business. The other pitfall in producing optimistic forecasts is that you may be held accountable for achieving these results during the negotiation process with a prospective investor and suffer the consequences for not achieving them.

Frequently Asked Questions (FAQs)

To raise financing, do I not need a prospectus or other legal document to distribute to investors?

Depending on which province your company is located in, you may not require a prospectus to raise financing. In Canada, securities regulations are governed by provincial jurisdiction and, therefore, each province has its own legislation pertaining to securities-related matters. Should you offer to sell an interest in your company to raise financing, it would be prudent to seek independent legal advice. For instance, in Ontario you may be exempted from providing a prospectus. This exemption comes under the seed capital exemption or private placement exemption of the *Ontario Securities Act*. To determine if you qualify under these or any other exemptions, you should consult with legal counsel.

In addition to my financing requirements, should I include the terms (i.e. price or valuation) I am looking for in my investment proposal?

The inclusion of valuation parameters or expected price of the shares you are offering depends on a number of factors. First, there is the sophistication of the prospective investors to whom you will be sending your investment proposal. Second, there is the number of prospective investors available and the likelihood of receiving more than one offer. The regulatory issues and requirements affecting the disclosure of information in your investment proposal are a third factor you should consider.

You should be cautious about the disclosure of your valuation parameters or your expected price. Although it may speed up the investor's decision as to whether to pursue your investment opportunity, it could lead to a quick rejection. If your price is too high, or if you give away too much by setting a low price, you may have to face serious financial consequences. In any case, your range of value or pricing, whether specifically disclosed in your investment proposal or not, must be realistic and defensible.

How long should my investment proposal be?

There are no rules for the length of the investment proposal. It should be long enough to provide prospective investors with the key information they need to make their decision. The only guideline is that the executive summary is usually two to four pages in length. Although there are no established guidelines, the longer the investment proposal, the less likely it is that the prospective investor will read the entire document due to time constraints. The investment proposal should be written in such a manner that it keeps the prospective investor's interest throughout.

Exhibit 4.1
New Tech Distributors Corp.
Income Statements

($000)	1998 Actual	1999 Forecast	2000 Forecast	2001 Forecast	2002 Forecast	2003 Forecast
Sales revenue	3,000	3,900	4,700	5,800	6,700	7,700
Cost of goods sold						
Purchases	610	710	800	920	1,050	1,200
Freight in	60	70	85	115	120	140
Labour	380	480	510	580	620	660
Depreciation and amortization	110	175	195	200	210	230
Other	25	30	35	40	48	45
Cost of goods sold	1,185	1,465	1,625	1,855	2,048	2,275
Gross margin	1,815	2,435	3,075	3,945	4,652	5,425
Operating expenses						
Selling expenses						
Salaries	620	780	820	840	875	890
Commissions	60	80	110	130	150	160
Travelling	60	90	115	120	130	140
Advertising	70	100	105	110	120	130
Depreciation and amortization	30	50	70	80	90	110
Other expenses & special promotion	17	220	100	100	110	115
Total selling expenses	857	1,320	1,320	1,380	1,475	1,545
Administrative expenses						
Salaries	395	420	465	510	545	570
Leasing	50	70	90	90	105	120
Depreciation and amortization	60	100	110	120	130	150
Research and development	50	100	100	100	110	120
Total administrative expenses	555	690	765	820	890	960
Total operating expenses	1,412	2,010	2,085	2,200	2,365	2,505
Operating Income	403	425	990	1,745	2,287	2,920
Interest income	5	6	8	10	10	10
Interest charges	95	115	155	155	160	160
Extraordinary expenses	0	0	0	0	0	0
Income before taxes	313	316	843	1,600	2,137	2,770
Income taxes	109	111	295	554	736	952
Income after taxes	204	205	548	1,046	1,401	1,818

Exhibit 4.2

New Tech Distributors Corp.
Balance Sheets

($000)	1998 Actual	1999 Forecast	2000 Forecast	2001 Forecast	2002 Forecast	2003 Forecast
Assets						
Current assets						
Cash	20	30	45	90	120	130
Marketable securities	100	110	120	140	230	600
Prepaid expenses	60	70	80	100	120	130
Accounts receivable	450	550	650	750	900	1,050
Inventory	350	425	475	560	700	790
Other assets	70	103	120	150	170	180
Supplies, etc.	84	120	140	180	190	200
Total current assets	**1,134**	**1,408**	**1,630**	**1,970**	**2,430**	**3,080**
Fixed assets						
Gross capital assets	1,775	2,875	3,615	4,700	5,800	7,400
Accumulated depreciation	560	885	1,260	1,660	2,090	2,580
Total net capital assets	**1,215**	**1,990**	**2,355**	**3,040**	**3,710**	**4,820**
Goodwill	**45**	**45**	**45**	**45**	**45**	**45**
Other assets	**5**	**5**	**7**	**8**	**10**	**13**
Total assets	**2,399**	**3,448**	**4,037**	**5,063**	**6,195**	**7,958**
Current liabilities						
Accounts payable	550	600	650	625	390	390
Term loan	125	140	170	160	100	70
Working capital loan	50	59	150	140	150	125
Accruals	60	50	80	79	71	71
Current portion of long-term debt	30	30	30	30	30	30
Total current liabilities	**815**	**879**	**1,080**	**1,034**	**741**	**686**
Long-term debts	**400**	**600**	**550**	**675**	**800**	**900**
Total liabilities	**1,215**	**1,479**	**1,630**	**1,709**	**1,541**	**1,586**
Owner's equity						
Capital shares	530	1,130	1,130	1,130	1,130	1,130
Retained earnings	654	839	1,277	2,224	3,524	5,242
Total owners' equity	**1,184**	**1,969**	**2,407**	**3,354**	**4,654**	**6,372**
Total liabilities and owners' equity	**2,399**	**3,448**	**4,037**	**5,063**	**6,195**	**7,958**

Exhibit 4.3
New Tech Distributors Corp.
Statement of Cash Flows

	1999	2000	2001	2002	2003
Operating activities					
Income after taxes	205	548	1,046	1,401	1,818
Depreciation expense	325	375	400	430	490
Marketable securities	-10	-10	-20	-90	-370
Prepaid expenses	-10	-10	-20	-20	-10
Accounts receivable	-100	-100	-100	-150	-150
Inventory	-75	-50	-85	-140	-90
Other assets	-33	-17	-30	-20	-10
Supplies, etc.	-36	-20	-40	-10	-10
Accounts payable	50	50	-25	-235	0
Term loan	15	30	-10	-60	-30
Working capital loan	9	91	-10	10	-25
Accruals	-10	30	-1	-8	0
Current portion of long-term debt	0	0	0	0	0
Total operating activities	**330**	**917**	**1,105**	**1,108**	**1,613**
Financing activities					
Capital shares	600	0	0	0	0
Long-term debts	200	-50	125	125	100
Dividends	-20	-110	-100	-100	-100
Total financing activities	**780**	**-160**	**25**	**25**	**0**
Investing activities					
Gross capital assets	-1,100	-740	-1,085	-1,100	-1,600
Goodwill	0	0	0	0	0
Other assets	0	-2	-1	-2	-3
Total investing activities	**-1,100**	**-742**	**-1,086**	**-1,102**	**-1,603**
Increase (Decrease) in Cash	-10	-15	-45	-30	-10
Cash - Beginning of Year	20	30	45	90	120
Cash - End of Year	30	45	90	120	130

Exhibit 4.4
New Tech Distributors Corp.
Financial Ratios

	1998	1999	2000	2001	2002	2003
Liquidity Ratios						
Working capital ($000)	319	529	550	936	1,689	2,394
Current ratio (times)	1.39	1.60	1.51	1.91	3.28	4.49
Cash ratio (times)	0.15	0.16	0.15	0.22	0.47	1.06
Quick ratio (times)	0.96	1.12	1.07	1.36	2.33	3.34
Working capital turnover (times)	9.40	7.37	8.55	6.20	3.97	3.22
Leverage Ratios						
Debt to total assets (percent)	50.64	42.89	40.38	33.76	24.87	19.93
Debt-to-equity ratio (times)	1.03	0.75	0.68	0.51	0.33	0.25
Times interest earned (times)	4.29	3.75	6.44	11.32	14.36	18.31
Fixed charges coverage ratio (times)	3.16	2.71	4.44	7.53	9.06	10.89
Management Ratios						
Average collection period (days)	54.75	51.47	50.48	47.20	49.03	49.77
Accounts receivable turnover (times)	6.67	7.09	7.23	7.73	7.44	7.33
Inventory turnover (times)	3.39	3.45	3.42	3.31	2.93	2.88
Day's sales to inventory (days)	108	106	107	110	125	127
Fixed assets turnover (times)	2.47	1.96	2.00	1.91	1.81	1.60
Total assets turnover (times)	1.25	1.13	1.16	1.15	1.08	0.97
Profitability Ratios						
Gross margin to sales (percent)	60.5	62.44	65.43	68.02	69.43	70.45
Operating income sales (percent)	13.43	10.9	21.06	30.09	34.13	37.92
Income after taxes to sales (percent)	6.8	5.26	11.66	18.04	20.91	23.61
Return on total assets (percent)	8.51	5.95	13.57	20.67	22.61	22.84
Return on invested capital (percent)	12.88	7.98	18.53	25.97	25.68	25.00
Return on equity (percent)	17.24	10.41	22.76	31.2	30.1	28.53
Other Financial Measurements						
Economic Value Added ($000)	62.0	-57.0	244.0	590.0	747.0	908.0
Company's growth rate (percent)		30.0	20.5	23.4	15.5	14.9
Sustainable growth rate (percent)		10.4	22.2	39.3	38.9	36.9
Financial health score	2.93	2.86	3.47	4.3	5.24	5.87

Module 5: Identify Potential Investors

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Executive Summary

The previous four modules examined the process of preparing an investment proposal in order to become investor ready. The next modules look at how to build investor relationships and focus on identifying potential investors, meeting investors, negotiating and closing the deal.

You may spend many months gathering information, and writing and reviewing your investment proposal in order to present a professional and distinctive document. All that effort can be wasted if your investment proposal does not make its way into the hands of targeted investors. The objective of the next modules has to do with building a strong and long-lasting relationship with a potential investor.

Before approaching investors, it is important to do some homework in terms of identifying and matching potential investors with your financing requirements. Finding the right investor is not an easy task because each has different priorities in terms of:

- the amount of funds they want to invest;
- the nature of the industry they want to associate with;
- the type of company they want to invest in,
- the geographic location of the business;
- the level of involvement they want to exercise in the business;
- the return on investment they want to earn;
- the development stage of the business; and
- the level of risk they are prepared to assume.

Before approaching investors, you will have to resolve three basic issues. First, you have to decide on the type and amount of funds you want to raise (i.e. debt versus equity). Second, you have to do your homework in terms of targeting the risk capital investor who will most likely be interested in your business. Third, you have to use a strategy that will help you successfully contact your targeted investor.

Compatibility between your business opportunity and your risk capital investor will be explored in the next modules. The process of establishing investor-entrepreneur relations is similar, in many ways, to traditional courtship. Throughout the scrutinizing process, both will be looking for mutual interests. Both will work hard to gauge compatibility because they know the relationship will be long term. When targeting risk capital investors, the entrepreneur should look for appropriate funds, trustworthiness, reputation, expertise, contacts and commitments.

Evidence suggests that only 30 out of 100 entrepreneurs are granted an initial meeting with risk capital investors after sending their investment proposal; *only one is financed*. On the basis of these statistics, the determining factor in securing a first meeting is the quality of your investment proposal because it is the key that opens an investor's door for you. And this is just the beginning. This module will help you develop a list of potential investors and contacts that are prioritized in terms of your funding requirements and compatibility with other needs and objectives. The goal of this module is to establish a road map to get you in the investor's door for a face-to-face meeting.

You may want to read the details of the module to get a conceptual view of identifying potential investors. Or, you may want to read the case example at the end of the module to learn how to apply some of the concepts and techniques presented in the module. However, the learning process will be enhanced if both approaches are used simultaneously.

The case example illustrates the importance of identifying potential investors. If you have been following the New Tech Distributors Corp. (New Tech) example, you are familiar with New Tech's background. This module shows how New Tech goes about identifying potential investors.

This module covers eight topics.

1. **Understanding the various sources of risk capital financing.** What are the various types of risk capital financing? You need to understand the various sources of funds to determine their appropriateness based on your company's development stage.

2. **Relationship between stages of development of a business and financing.** At what stage of development is your business? Investors are interested in backing businesses at a specific development stage (e.g. start-up versus expansion).

3. **Risk and sources of financing.** How do investors gauge investment risk when businesses are at different stages of development? Risk is different in a start-up venture versus an expansion.

4. **Identifying potential investors.** How do you go about ranking potential investors? This section shows how to match your interests with those of potential investors in terms of stage of development, capital required, geography, industry and leadership.

5. **Resources available to find investors.** What can an entrepreneur do to find investors? The concept of "one-stop shopping" for funds is not common in the lending community. Investors have different interests, and there are resources available to help you match your financial needs with appropriate investors.

6. **Understanding the characteristics of potential investors.** What are the basic characteristics of the potential investors you want to contact? When meeting with an investor, you have to be prepared to ask the right questions in order to compare your needs with those of the investor.

7. **Understanding preferred investor's criteria.** How do you choose an investor who is a match for you? This section summarizes how you should go about understanding your preferred investor.

8. **Legal implications.** What legal and regulatory requirements must you consider when identifying potential investors? These will have an impact on the number and nature of potential investors you decide to contact.

Details

1. Understanding the Various Sources of Risk Capital Financing

Financing falls under two general categories: debt and equity. *Debt financing* is taking out a loan from a funding source and paying interest on it. *Equity financing* means obtaining funds in exchange for selling or giving up a part interest in the business. Equity financing has become very popular in recent years, especially in fast-growth businesses. These companies often have a product concept for which development costs can be considerable. Because they do not have the equity, collateral or ability to repay any type of loan, they sell a portion of their business to raise money. Risk capital investors may be interested in either debt financing or equity financing. In most cases, however, equity financing will be their preferred funding option.

The basic outline of your investment proposal will remain the same as the one presented in Module 4, Build an Investment Proposal. The emphasis placed on each section of the proposal depends, to a large extent, on the type of risk capital investor you want to approach. There are many potential investors who might fund your business and you might be interested in presenting your investment proposal to:

- founder capital;
- angel investors;
- private investors and venture capital firms;
- institutional investors (financial institutions, insurance companies and pension funds);
- government-backed corporations; and
- corporate strategic investors.

Founder Capital

The most logical place to look for financing is your own assets. These sources include money in the bank, certificates of deposit, shares and bonds, cash value in insurance policies, real estate, home equity and pension funds. This is known as *founder capital*. Another common source is financing from family, relatives and friends, which is known as *love money*. If you borrow from relatives and friends, make sure to spell out clearly the terms of the funding agreement (including the date, amount of loan, interest rate, repayment schedule, collateral, signatures) to avoid future problems and disagreements.

Founder capital and love money are also known as *seed money*. Generally, the amount of money required is small and is suitable for early stage financing. Seed funds are used by an inventor or entrepreneur to test a concept. Other uses include product development, market research, building a management team, developing a business plan, developing and market testing a prototype, or initiating manufacturing and sales.

Founder capital and love money are important because most other investors would find the project too risky. Even if risk is high, potential rewards are significant.

Angel Investors

Angels are generally individual investors. They may include professional investors, retired executives with business experience and money to invest, or high net worth individuals simply looking for investment opportunities. This could be the most difficult sector for you to access because angels do not advertise nor make themselves known to the general public. Your best sources of leads for reaching angels are referrals from your banker, accountant or lawyer, or other people who have established contacts with these individuals.

Many angels are sophisticated investors and will go through the formal due diligence review. They will want to look at your detailed investment proposal and will ask for references.

Angels will usually invest $25,000 to $300,000. Most angels require that you invest a considerable amount of your own money in your business to make sure you are fully committed and prepared to take the appropriate levels of risk.

Angels typically bring much more than money to your business; they have experience and know-how. They will usually want to play an active role in your business, which will provide some strategic orientation. The skills and experience of these angels can work to your advantage since they can sometimes provide the expertise your management team may lack.

Private Investors and Venture Capital Firms

These individuals or groups almost always provide funding for an equity or ownership in a business. They work with new business start-ups and existing businesses. These individuals or firm managers are professionals with a vast amount of experience, contacts and business skills that can help your business become more profitable. These investors are looking for annual average returns of 30% and 40%.

The size of their investment can range from $25,000 to $5 million. Some larger firms will invest as much as $5 million. However, typical investment deals range between $500,000 and $3 million, with firms setting minimum and maximum limits for their investments.

Investors in this category have particular preferences, strategies and investment criteria. While some private firms will be more interested in investing in the development stage, many will be interested in companies involved in the expansion, acquisition and management/leveraged buyout stages.

These investors include labour-sponsored venture funds. These funds have emerged as dominant players in the private investment marketplace. Firms such as Working Ventures Canadian Fund, Fonds de Solidarité and Canadian Medical Discoveries Fund have significant amounts to invest. Some investors have the flexibility of investing in different regions of Canada while others are more interested in a particular province. Many will invest in the form of equity or in subordinated debt that is less than $1 million.

Institutional Investors

Institutional investors provide equity and subordinated risk capital investment to small and medium-sized businesses. They include subsidiaries of commercial banks, investment banks, certain life insurance companies and pension funds.

These companies fund investments that are less than $1 million, as well as larger ones. Canada has a wide range of such organizations including Bank of Montreal Capital, Royal Bank Capital Corporation, CIBC Wood Gundy Capital, Penfund Partners, Investissement Desjardins, Roynat, Ontario Teachers' Pension Fund, OMERS and TD Capital.

Government-backed Corporations

Federal and provincial governments have recognized the importance of supporting the development of small and medium-sized companies. Investments are often made in smaller, regional communities where mainstream investors are less active. For example, the Atlantic Canada Opportunities Agency provides support to businesses located in the Atlantic provinces. The Business Development Bank of Canada (BDC), formerly the Federal Business Development Bank, operates across Canada. The BDC was once considered a lender of last resort, but not today!

The BDC is unique in its status because it offers a one-stop shopping service. Its mission is to help create and develop Canadian small and medium-sized enterprises (SMEs). The BDC provides financing tailored to commercially viable business projects, together with counselling, training and mentoring assistance. Some of the programs it offers include:

- Venture Loans, which provide quasi-equity instruments in amounts ranging from $100,000 to $1 million for expansion and market development projects;
- Working Capital for Growth funding, available up to $100,000;
- Patient Capital, directed at knowledge-based businesses in the early stages of development, offered on a long-term basis for up to $25,000; and
- Micro-Business Program, which provides training and counselling to very small companies, along with up to $25,000 for new businesses and up to $50,000 for existing businesses.

Like some other venture capitalists, the BDC offers term loans for expansion projects, plant overhauls, acquisitions, refinancing and the purchase of capital assets. The BDC also invests in businesses through equity and debenture finance arrangements.

Corporate Strategic Investors

Corporate strategic investors differ from traditional venture capital companies in that their motivation extends beyond financial reasons. Their business agreements are also referred to as *strategic alliances* or *corporate partnerships*. A strategic investor may have a broad range of objectives that include enhancing innovation, gaining exposure to new markets and technologies, identifying and accessing acquisition candidates, assuring sources of supply, assisting a client, initiating new ventures internally and spinning off businesses that are not appropriate for in-house purposes.

Business arrangements fall into three broad categories.

Partnering. The objective of partnering is to gain access to a product. The time frame is short — less than two years. An example would be the development of a software computer product that is compatible with the investor's existing production.

Directed Venturing. The objective of directed venturing is to complement long-term development plans. The time frame is two to seven years. For example, a corporation providing branch banking computer software programs may be interested in linking with an entrepreneur developing applications for Internet service providers.

Corporate Venturing. The objective of corporate venturing is to protect territory. The time frame is long term — up to 20 years. The corporate strategic investor wants to remain state of the art, to stay competitive and protect market share.

Compatibility is a key factor in the creation of a corporate strategic partnership.

2. Relationship Between Stages of Development of a Business and Financing

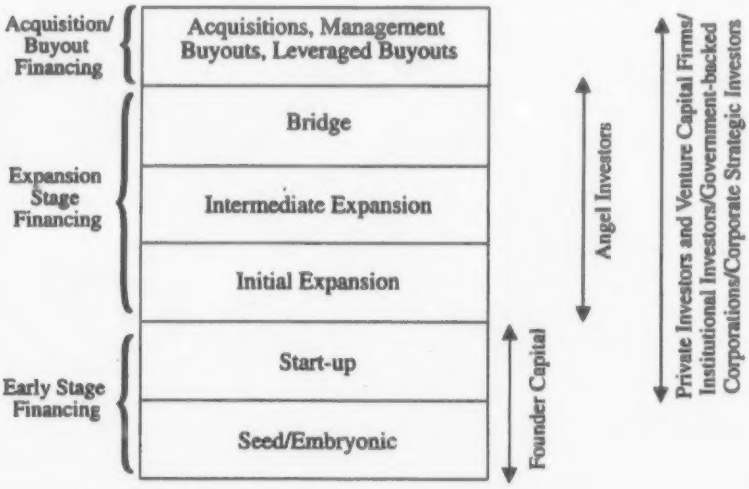
Risk capital investors want their investments to be as productive as possible. A large number prefer to invest their funds in the production and marketing of products as opposed to support for engineering, testing, market research and other product development activities. The closer the product is to being marketed, the lower the risk and the faster profits can be realized.

Investors rate investment opportunities according to overall risk and desirability of the business venture. To determine the inherent risks, investors will rank projects under three basic categories:

- early stage;
- expansion stage; and
- acquisition/buyout.

Figure 5.1 shows the type of projects, in terms of their development stage, that investors will be interested in funding. The following gives a brief description of each phase.

Figure 5.1
Stages of Development


Acquisition/ Buyout Financing
Acquisitions, Management Buyouts, Leveraged Buyouts
Expansion Stage Financing
Bridge
Intermediate Expansion
Initial Expansion
Early Stage Financing
Start-up
Seed/Embryonic
Founder Capital
Angel Investors
Private Investors and Venture Capital Firms/ Institutional Investors/Government-backed Corporations/Corporate Strategic Investors

Early Stage Financing

Projects in the early stage include investors who provide seed/embryonic and start-up financing.

Seed/embryonic financing can cover preliminary research and development, developing a prototype, preliminary market research and patent or licence applications. It may also include projects requiring modest working capital financing.

Start-up financing is for companies completing product development and initial marketing. These companies may also be setting up their organizational activities; they may have been in operation for less than one year, but have not marketed their product commercially. These companies need money to fund a prototype or get involved in full-scale manufacturing and sales activities.

Expansion Stage Financing

The expansion stage can be broken down into three levels: initial expansion financing, intermediate expansion financing and bridge financing.

Initial expansion financing involves companies with full-scale production and sales activities that have not yet generated a profit. Since such companies are in a growth phase, funds are needed to provide working capital financing for investments in accounts receivable and inventories.

Intermediate expansion financing is of interest to businesses that are growing and profitable but need to expand their production requirements to meet increasing sales volumes. Such financing will be applied to expansion, marketing, working capital or product improvement purposes.

Bridge financing is interim financing. These funds are used to help companies go public within a reasonably short period, usually six to 12 months. The funds also help to finance underwriting costs and restructure existing stockholdings.

Acquisition/Buyout Financing

This type of financing includes acquisitions, management buyouts (MBOs) and leveraged buyouts (LBOs). It involves a small group of equity investors who acquire a firm in a transaction financed largely by borrowing. The debt is paid off with funds generated by the acquired company's operations or through the sale of some of its assets. Generally, the acquiring group plans to run the acquired company for a number of years, boost its sales and profits, and than take it to the investment public as a stronger company. Naturally, the acquiring group hopes and expects to make substantial capital gains from the operation, but it recognizes the risks inherent in the initial heavy use of leverage.

These funds are required to invest in the purchase of a product line or entire business. Acquisitions and LBOs usually involve outside or third-party buyers. An MBO refers to a transaction where a firm's own managers set up a new company whose equity comes from the managers themselves and from some pension funds and other institutions. The acquired company is made up of the existing operating management group. MBO management tends to be entrepreneurial in nature.

The target investment may be at any stage of development. Many MBOs originate to save the jobs of the purchasers and other employees. This situation arises when the parent company (the seller) deems an operation, division or subsidiary no longer suitable and intends to shut it down or sell it.

3. Risk and Sources of Financing

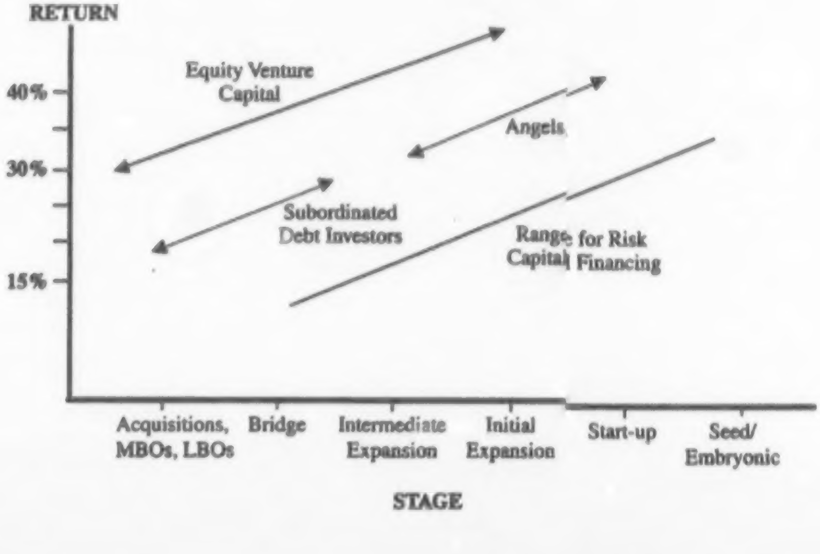
Every company, new or existing, big or small, has an inherent level of risk. At the early stages of a company's development, the risk tends to be highest. Generally, in its initial phase, a company has a promising but unproved product and requires equity funding to push it through to the next stage of development. In these circumstances, the risk is high and liquidity is low. As a company matures and begins to prove itself, the level of risk diminishes. As well, access to capital improves.

Investors will share in the success or failure. Since there is a high level of uncertainty, investors will be interested if the company shows a high return on investment — possibly as high as 40% or more a year. It is important to recognize that there is typically a low cash cost for an equity investment for the "investee" company. Investors generally reap their return through the sale of shares on the securities market.

The relationship between a company's risk and expected returns determines, to a large extent, the type of investor that would be interested in investing in such a venture. Risk may be defined as the range of possible cash flows resulting from an investment; the greater the range, the greater the risk. It is important to approach investors with investment criteria that complement a company's profile and proposed financing instruments. In other words, the investor and the company should be consistent in terms of how they view risk.

Figure 5.2 presents the source and type of financing that could be available relative to the stage of development of a business. The development stage of your business can serve as a benchmark to identify the appropriate source of risk capital.

Figure 5.2
Risk and Sources of Capital



The figure isolates only risk capital financing sources. If your company is in an early stage of development and you have good collateral against which loans can be pledged (e.g. accounts receivable, inventories, equipment, real estate, guarantees), you may be able to attract lower risk (and, therefore, lower cost) investors. Examples of low-risk capital lenders include commercial banks, mortgage lenders and lease financing. In this situation, due to the available collateral, the risk is less and, therefore, the financing instrument used may cost less.

4. Identifying Potential Investors

Unfortunately, investment opportunities are often rejected because an entrepreneur does not understand the needs, requirements and specialization of the investor he or she is trying to attract. Identifying the right investor is a critical step when raising funds. If you approach the wrong investor, you run the risk of being rejected. Also, it is important to remember two other points:

- Once rejected, always rejected. It's hard to get a second chance with the same investor.
- An "over-shopped" reputation reduces your chances of attracting funds. Investors have their own networks and they may talk to each other.

Network effectively. You should exploit, to the maximum, your business and personal acquaintances. Try to contact anyone who may be able to make meaningful introductions or referrals.

This section will help you develop a prioritized ranking system for selecting and approaching risk capital investors who best match your needs and interests. But first, you need to go through a two-step process: categorize potential investors based on certain criteria and then rank these investors using a priority matrix.

Step 1: The Criteria

The first step requires you to identify the criteria relevant to your business venture. The more important and common criteria are:

- capital required;
- industry;
- geography;
- leadership; and
- stage of development.

Capital Required

Private, institutional and government-oriented investors will establish upper and lower limits in terms of preferred investment size. It is important here to distinguish between investment size and the deal size. An investor may take a share of a large deal, as long as the amount fits his or her investing limits.

Investors will also prefer certain types of investment vehicles. The type of deal for the Canadian market is approximately 39% common shares, 12% preferred shares, 15% subordinated debt, 11% debt with common shares, 12% convertible debt and 11% from other sources.[1]

Industry

There is strong evidence that investors are becoming more interested in specific industries. Knowing an investor's industry specialization is helpful for two reasons.

- You can avoid wasting time with an investor if your company does not share his or her industry focus.
- If an investor understands your industry, he or she can bring you helpful experience and valuable contacts. Also, given an investor's industry knowledge, his or her ability to make knowledgeable and quick decisions will likely be an advantage.

Geography

Geographic location is important to most investors, particularly those who want to be active in your business. Geographic proximity is less important with larger firms, where certain activities are centralized and where local field representatives are easily accessible. There are advantages in approaching an investor located close to your business.

- You may acquire added value due to local business contacts and knowledge.
- It will make it easier for your investor to oversee his or her investment.
- You may have a common objective to support and encourage regional development.

Leadership

Certain investment firms are leaders; others are followers. If you are looking to syndicate your deal, involving a number of investors, you may wish to approach leaders. These investors will take the lead and organize the syndication process for you. They will capitalize on their reputation and networking skills to bring together an investment team.

Stage of Development

This topic was covered earlier. It is important to approach a risk capital investor who will be interested in the stage of development your business is in now (early stage, expansion stage or acquisition/buyout).

Step 2: Prioritize Potential Investors

Once you have identified your criteria for selecting investors, the next step is to rank them using a value system.

Table 5.1 shows a simple matrix system that can help you rank and prioritize your targeted investors. As shown, itemized criteria are given a numerical value (0 to 2) to determine the most appropriate investor. After assigning a value to each criteria and for each investor, the matrix gives you the ranking. The numerical value is based on the following:

- 2 equals a good fit with your business venture;
- 1 equals a so-so fit; and
- 0 represents no fit.

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[1] Canadian Venture Capital Association, 1997 statistics.

Table 5.1: The Investor Ranking Matrix

	Potential Investors		
Criteria	**A**	**B**	**C**
Capital Required	1	1	2
Industry	2	2	2
Geography	1	0	2
Leadership	1	0	2
Stage of Development	1	2	1
Score	**6**	**5**	**9**

Source: G. Jackson Tankersley Jr., *How to Choose & Approach a Venture Capitalist*

Investors showing the highest score would have the best investor-entrepreneur fit. When using this approach, there could be no-go situations. For example, if a potential investor scores high in every category, but low in industry, then you may want to strike this candidate altogether, regardless of the overall score.

In conclusion, it is advantageous to target potential investors that best fit your business profile. This will increase your chances of success when contacting investors. For more information, refer to the Meet Potential Investors module.

5. Resources Available to Find Investors

The investment community is large, spread out and very fragmented. The following sources can help you identify potential investors.

Directories/Associations. Canadian Venture Capital Association (CVCA); *Pratt's Guide to Venture Capital Sources* (primarily U.S.); Statistics Canada. A business library may be able to assist you.

Industry Information. Consult industry/trade associations, Statistics Canada, the Internet.

Media. Do a media search for news articles (again, your library can assist). Follow reports of completed deals. Keep your eyes open for advertisements about investors showing an interest in investing.

Known Players. Identify known players in the venture capital market. You can always seek their advice, as opposed to soliciting their investment.

Advisors. Seek guidance from your accountant, lawyer or other consultants. These can be valuable sources. Paying a consultant may be a worthwhile investment. You can also join investor associations with the objective of expanding your network and finding a mentor.

Mentors. Discuss your intentions with your advisors and let people know what you are looking for.

Government. Speak to your local Chamber of Commerce and other similar agencies. The Business Development Bank of Canada (BDC) may also be helpful.

In addition to compiling information from these various sources, another possible tactic is to attend trade shows, conferences and investment forums. These are excellent venues for cultivating your network and developing contacts. Consider doing a presentation and setting up a booth at such events. You need to be well prepared, but in the end, it is a good opportunity for exposure and for advertising your business venture.

6. Understanding the Characteristics of Potential Investors

Choosing an investor means you are prepared to work with a business partner. If this is the case, you should make a serious effort to appreciate his or her idiosyncrasies and the way he or she works. The things to look for should include:

- level of involvement (required by the investor);
- decision-making process;
- character, reputation and credibility;
- commitment and staying power; and
- other resources.

Level of Involvement

Some investors will take an active role, such as advising on critical matters, taking part in the strategic planning process, providing input to your decision making and promoting your business through sourcing and networking. Other investors may be more interested in taking a passive, hands-off approach.

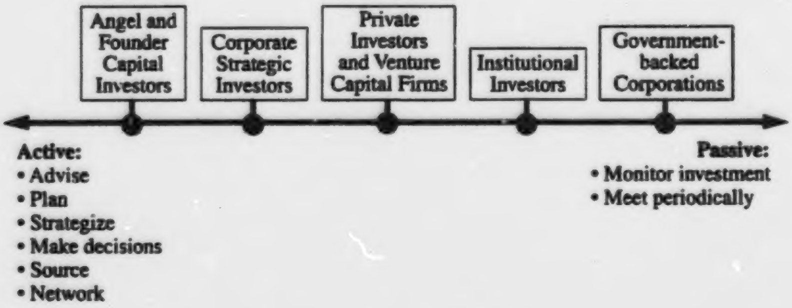
Angel investors tend to be actively involved in a business. Institutional investors tend to take a more passive role.

Depending on your particular requirements, you may have a preference regarding an investor's level of involvement in your decision-making process. It is important to match your preference with the involvement profile of potential investors.

Entrepreneurs used to running their business as they see fit would be reluctant to consider an active investor. However, an entrepreneur may find it appropriate to deal with an investor who will bring management and business skills to the business.

Figure 5.3 gives a spectrum of investors categorized by their general level of business involvement.

Figure 5.3
Level of Involvement


Angel and Founder Capital Investors
Corporate Strategic Investors
Private Investors and Venture Capital Firms
Institutional Investors
Government-backed Corporations
Active:
• Advise
• Plan
• Strategize
• Make decisions
• Source
• Network
Passive:
• Monitor investment
• Meet periodically

Decision-making Process

How compatible is your decision-making style with that of the potential investor, and to what extent does the investor want to be involved in the decision-making process?

The decision-making style may be determined by the following:

- Who should make the decisions?
- What is the decision-making process?
- How long will it take to make the decisions?
- What is the likelihood for mutual agreements?

The extent of a potential investor's involvement in the decision-making process can be determined by the following:

- Which issues will require the investor's prior approval?
- How will he or she respond to any deviations (small or significant) from the investment proposal?
- Who will be your contact in the investment firm? What is your expectation regarding continuity? If the investment firm is a corporation, has staff turnover been high?
- Who is the decision maker in the firm?
- How long will it take before getting approval on a decision?

If the processes and procedures of a potential investor do not suit your needs, you should reconsider the appropriateness of the fit.

Character, Reputation and Credibility

It is important to consider the potential investor's character, reputation and credibility. Look at previous investment deals, the level of the investment, the size of company and the success factor. Talk to colleagues and professionals; see if anyone knows the investor's background and past performance. You may ask the investor to provide names of companies he or she has dealt with in the past.

> Select your investors wisely. They will be your business partners. Consider their reputation, commitment, compatibility of goals, time horizon, flexibility and integrity.

Commitment and Staying Power

There are two important elements to consider when gauging the commitment and staying power of a potential investor.

- You want to make sure your investor is firmly established and not facing any financial constraints. Additional funds may be important in case you want to deal with a future problem or take advantage of an opportunity.
- It is vital for your investor to be unconditionally committed to your business. Often, it takes time to fulfil growth plans. Make sure the investor is committed for the long term. Also, consider whether your strategies are compatible.

Other Resources

You need to explore the full nature of your proposed relationship. Understand your company's needs and compare them to those of your potential investor. In addition to funding, other matters to consider are the investor's:

- knowledge of your market;
- understanding of your industry and technology;
- distribution or marketing networks that may assist in promoting your business; and
- contacts.

Questions You May Want to Ask Potential Investors

To ensure that you fully understand the needs of your investor, you may want to ask the investor the following questions:

- What role do you want to assume in our business? Do you intend to be an active or a passive investor?
- What is your decision-making process for approving capital expenditures?
- What type of restrictions would you want to impose on our business?
- Will you agree to a confidentiality agreement?
- Who will hold the rights to our technology (i.e. patents)?
- Are you dealing with competitors (i.e. are there any conflicts of interest)?
- What restrictions and reporting requirements are you going to implement?
- Can you comment on your experience as an investor? What are your contacts? Do you have any references?
- What deals have you consummated in the past?

This is by no means an exhaustive list, but it gives you an idea of some of the intangibles you should consider.

7. Understanding Preferred Investor's Criteria

It is important to remember that the end result of finding investor financing may be a partnership. This partnership needs to be mutually beneficial and ultimately profitable. The investor will fully scrutinize your business venture. Likewise, you must make every effort to understand your investor thoroughly. You need to get into a compatible and complementary relationship.

Therefore, when developing your target list of potential investors, make sure the basic selection criteria fit your profile in the following areas: capital required, industry, geography, stage of development and leadership (for syndication purposes). Identify your needs beyond the obvious infusion of capital: contacts, expertise, planning, commitment, reputation and trustworthiness. Determine if your potential investor has these attributes.

> Don't let money drive the deal. Consider other intangible factors.

Your search does not end here. When you eventually meet potential investors, critique their character. You need a constructive, non-adversarial arrangement. Define the role the investor will play. Is the role acceptable to both of you?

8. Legal Implications

Although you have written your investment proposal, you may need to adjust its content. Depending on the number, the nature, the degree of sophistication and other characteristics of your potential investors, you may be subject to certain legal and regulatory requirements. Before finalizing your investment proposal and contacting investors, you should seek the assistance of an experienced legal counsel.

9. Conclusion

You have now completed the first step in building investor relationships. In this module, you looked at:

- various types and sources of risk capital financing;
- how to rank and narrow down the list of potential investors;
- resources to assist you in your search for the most suitable investor;
- understanding the characteristics and needs of various investors; and
- some legal and regulatory considerations.

In the next module, Meet Potential Investors, you will examine how to approach potential investors, how to make an advantageous and favourable first impression, how to present your investment proposal effectively, what to expect and how to conduct yourself during your first meeting.

Case Example

This case example allows you to follow a fictitious company, New Tech Distributors Corp. (New Tech), as it seeks risk capital to finance its growth. The case shows how New Tech addresses the key elements presented in the Details *section of each module.*

If you have not already done so, read about New Tech's background and the challenges it faces in the earlier modules. As well, you may wish to refer to the Steps to Growth Capital Overview for an introduction to the overall structure of this program.

New Tech is now preparing to meet potential investors after completing the activities outlined in modules 1 to 4. Read about how New Tech identifies a list of potential investors. You should refer to the Details *section of this module for more information related to this subject. Specifically, you should refer to New Tech's list of potential investors (See Table 5.2 on page 18) as you review this case.*

The Investors

With the investment proposal nearing completion, New Tech must now identify potential investors. Elizabeth Pratt (New Tech's accountant) consults with Tony Lee of Smith & Smith, New Tech's solicitors, to determine if there are any exemptions in the securities the company could qualify for and how this would affect their investor contact program.

Stuart Chip (New Tech's CEO) calls Grant Agent (New Tech's financial advisor) for a meeting with Elizabeth and himself. Grant explains that there are different categories of investors: angel investors (typically, wealthy businesspeople with contacts), institutional investors (the pension funds and life insurance companies or their agents), labour-sponsored venture funds, government-backed corporations such as the Business Development Bank of Canada and so forth. Each investor has personal investment preferences, making some more attractive than others.

Grant emphasizes the point that it is very important to ensure that the type of investor matches New Tech's priorities and objectives. Stuart indicates the criteria he feels are important in selecting an investor who will be compatible with New Tech's needs.

Chemistry. The investor has to be someone with whom the management team can work easily.

Staying Power. The investor has to be committed until the next round of financing is required, if necessary.

Value-added. The investor should be experienced; someone who understands businesses and, better yet, has personally run one.

Active. Since New Tech has shown strong growth, it would benefit from an active investor, particularly one who has experience with fast-growth businesses throughout the latter stages of development.

Industry Experience. It would be preferable if the investor has knowledge of the computer industry.

Geography. The closer the investor, the better.

Using Stuart's criteria, Grant does an extensive search based on his contacts and various data bases. He subsequently presents Stuart and Elizabeth with a list of nine potential investors. He indicates that he has included a couple of passive investors. He feels Stuart might benefit from meeting with a passive investor just to see the difference in management style, since it is his first time through the process. Grant also adds that it is not unusual for a syndicated deal to take place when an active investor joins a passive investor who trusts his or her business acumen.

Targeting the Investors

After a three-hour discussion about the pros and cons of the nine potential investors listed in Table 5.2, Grant informs Stuart and Elizabeth that he has dealt with most of them and knows their reputations and past investment deals. Stuart thinks the Equal Opportunity Fund may be considered too passive. Walter Buffet is of great interest to Stuart since he is a well-known investor and made a great deal money when he first invested in a computer company. He also seems to have staying power in that he considers investing between $500,000 and $5 million. Initially, Elizabeth likes the idea of approaching the Bank of Kelowna Capital; however, Stuart is not as responsive to the idea because of the organization's lack of entrepreneurial spirit in view of the fact that it is part of a banking institution.

Stuart rejects Pine Capital because he knows the president of a company that Pine invested in. He makes a telephone call to the president and finds out that the company was unhappy with Pine primarily because it was not adding any value to the firm. Neither Fond de Montréal nor Big Chartered Bank Capital Corporation has any high tech experience, and Stuart believes they are located too far away.

By this time, Stuart is wondering whether Grant was sensitive enough to his investor criteria. Both Elizabeth and Stuart are intrigued by Van-Hong Ventures. Stuart has expressed an interest in Asian markets for New Tech's product, but feels the company would have enough on its plate just focussing on the North American market. Grant agrees that investors are reluctant to invest in businesses that lack focus, that is, those that want to expand at all costs. He thinks that a company with $3 million in sales and a huge North American market should keep its domestic focus. In addition, New Tech's 24-hour delivery program is the key for maintaining its competitive advantage but would not be considered an important factor in the Far East without opening a distribution facility.

Table 5.2: New Tech Distributors Corp. List of Potential Investors

#	Rank	Name	Type of Investor	Financing Instrument and Investment Size	Investment Criteria	Location	Active/ Passive	Industry Preference	Comments
1		Equal Opportunity Fund	Labour-sponsored venture fund	Equity - common shares $500,000 - $5 million	- Established companies only - Revenues up to $50 million	Vancouver	Passive	All industries except real estate	- Largest fund in Canada - Minimal monitoring requirements
2		Walter Buffet	Individual investor	Equity - common shares $500,000 - $5 million	- Established companies or start-up	Victoria	Active	Manufacturing High tech	- Ex-CEO of Fiji Technologies - Large pool of capital - 55 years old
3		Bank of Kelowna Capital Corporation	Institutional investor	Subordinated debt and equity $250,000 - $2 million	- Established companies only - Revenues up to $20 million	Vancouver	Active	All industries except real estate	- Financing arm of Bank of Kelowna aimed at small to mid-sized business
4		Pine Capital	Private venture capital fund	Subordinated debt and equity $1 million - $5 million	- Established companies or start-up - Revenues up to $35 million	Toronto	Active	Manufacturing Retail High tech	- Group of private investors - Minimal background in high tech industry - High monitoring requirements, likes to be active in operations
5		Van-Hong Ventures	Private international venture capital fund	Equity - common shares $500,000 - $10 million	- Established high growth companies - Revenues up to $50 million	Vancouver Hong Kong	Active	High tech only	- International private investors seeking to add to portfolio of investments in high tech companies around the world - Must be a high growth company with strong management - May provide access to Asian markets
6		George Van der Meer	Individual investor	Equity - common shares $100,000 - $1 million	Established companies or start-up	Burnaby	Active	All industries except real estate	- Very wealthy and retired - Invests in small business and helps them grow - Past experience in computer components industry - Recently invested in a similar situation
7		Big Chartered Bank Capital Corporation	Institutional investor	Subordinated debt and equity $250,000 - $2 million	- Established companies only - Revenues up to $50 million	Toronto	Passive	All industries except real estate	- Financing arm of Big Chartered Bank of Canada aimed at small to mid-sized businesses - Based in Toronto and mostly interested in larger deals in non-high tech industries
8		Chinook Ventures	Private venture capital fund	Subordinated debt and equity $250,000 - $2 million	- Established companies or start-up - Revenues up to $25 million	Calgary	Active	All industries except real estate	- Focusses on helping Western Canadian-based businesses - Provides management services and contacts as well as capital
9		Fond de Montréal	Labour-sponsored venture fund	Equity - common shares $500,000 - $3 million	- Established companies only - Revenues to $50 million	Montréal	Active	All industries except real estate	- Focusses primarily on opportunities in Quebec and Eastern Canada - Takes an active role in operations

Grant knows George Van der Meer personally and says he is a very astute investor who has successfully exited from most of his investments in the recent initial public offerings (IPO) market. He is looking for new investment opportunities in which he could be actively involved. However, Stuart is concerned about his staying power; given his age, he might just want to retire before New Tech reaches the next stage.

Chinook Ventures is well known in Western Canada. It has been around for 15 years, has an excellent track record and expertise in technology. Although based in Calgary, Chinook recently announced the opening of a Vancouver office.

After three hours, Stuart and Elizabeth, with some coaching from Grant, rank the investors. Grant explains that he will arrange two meetings. Buffet was ranked first, followed by Chinook Ventures and George Van der Meer.

Author's Note:

New Tech has identified several sources and is prepared to reduce the number of potential investors down to a short list. This was an important step that required careful consideration. New Tech has learned that:

- *it is necessary to investigate legal and regulatory issues that could affect the investors it will approach;*
- *there is a range of investors who have different interests for investment;*
- *investors have a wide range of needs which, in the end, must closely match New Tech's priorities and objectives;*
- *it may have to go through a number of investors to find the right one;*
- *it should be methodical in its search, and should consider both tangible and intangible selection criteria in its final decision; and*
- *it should rank the short list and be able to justify the decision to its own management team.*

Myths

Investors are all the same.

This is not so. Investors are different in terms of character, policies and procedures, and level of involvement. They all have different investment criteria regarding the size and type of deals, geography, stage of development and industry. As well, certain investors will lead deals, and others will follow.

There is no reason for investors to be involved with my business, except if there is a problem.

This is misleading. Many investors bring much more to a business than just money. They can add value by providing management and business expertise, and strategic advice by being a sounding board, and providing contacts and solving problems. Investors should be encouraged to take an active role in your business. This serves to cement their commitment to your company, which may be especially important if something does go wrong.

Investors are only interested in money.

This is not necessarily so. There may be intangible reasons for an investor to make an investment. Thus, it is important to understand an investor's overall strategies. Make sure these strategies blend well with your objectives and strategies.

Frequently Asked Questions (FAQs)

How many investors should I target at one time?

At the beginning, you should approach only one or two. You should try to gauge their reactions. Based on their feedback, regroup and make the necessary changes to your investment proposal. Be careful to avoid the "over-shopping" frenzy. As much as possible, avoid rejections based on your approach, as opposed to your project's viability. Once you have been turned down, it is difficult to have the same investor give you a second chance.

How do I get information on a particular investor's selection criteria?

- Telephone them. They usually are quite willing to share this information.
- Members of the Canadian Venture Capital Association (CVCA) and Réseau Capital publish their key criteria on their Web sites at **http://www.cvca.ca** and **http://www.reseaucapital.com** respectively.
- Contact the Business Development Bank of Canada (BDC) and ask for advice and assistance.

Where do I go to get a list of investors?

Here are a few suggestions:

- Business Development Bank of Canada (BDC);
- Canadian Venture Capital Association (CVCA);
- *Pratt's Guide to Venture Capital Sources* (mainly U.S.);
- Statistics Canada; and
- Internet networks.

Module 6: Meet Potential Investors

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Executive Summary

In the previous module, we examined how to go about preparing a preliminary list of potential investors. The next several modules focus on the techniques necessary for establishing and cultivating a strong business relationship with your potential investor. This module looks at how to prepare yourself for meeting these prospective investors. You must be able to prepare a convincing written case for funding and then present a convincing oral case.

Now that you have written your investment proposal (presented in Build an Investment Proposal) and identified the most appropriate investors for your investment opportunity (presented in Identify Potential Investors), you should develop a strategy to establish contacts with potential investors. The objective is to secure a first meeting with at least one seriously interested party.

> "It's not only who you know, but how you get to know them." (Anonymous)

You can go through this module in two ways. You may want to read the details of the module to get a conceptual view related to meeting potential investors. Or, you may want to read the case example at the end of the module to learn how to apply some of the concepts and techniques presented in the module. The learning process will be enhanced if both approaches are used simultaneously.

During this phase, it is important to remember that you are seeking an investment partner to share a financial risk with you, in return for a fair share in the growth of your business. This association is very different than other forms of business and conventional financing relationships. It is more of a partnership arrangement. The primary purpose of the initial meeting with your prospective investor is to lay the groundwork for what is expected to be a long and prosperous relationship.

Getting that first meeting with a potential investor is important and can be achieved in numerous ways. A meeting will likely be required to present your investment proposal and answer additional questions (or provide further information) that may not be covered by the proposal. The initial meeting could also lay the foundation for the possible preparation of the due diligence review.

As an entrepreneur, your initial meeting with a potential investor is usually your first real opportunity for a meaningful interaction; you get a chance to convince your prospective investor of the objectives and strategies for your business. A key thing to remember is that your investor has something you want (capital), and you have to convince the investor that you have something he or she wants (a good return). You therefore have to do your utmost to persuade your potential investor that your business opportunity meets his or her requirements in terms of expected return, level of acceptable risk, timing and exit strategy. The tangible factors an investor will be looking for during a first meeting include the following:

- How well prepared is your management team?
- How coherent are the members of your management team in explaining your company's products and markets?
- How good are they in selling your business and concepts?
- Are they truly market-oriented or simply technologists with no business savvy?
- Are they quick on their feet?
- What kind of integrity do they have?

- What is the chemistry among the members of your management team?
- How receptive are they when they face constructive criticism? Are they willing to take advice?

The primary purpose of the initial meeting with a prospective investor is to lay the groundwork for a long and prosperous relationship.

The initial meeting and the circumstances leading up to the meeting must be addressed in a logical and comprehensive manner. It is important to feel confident about your project, to be well prepared, and to have a clear understanding of what you want to accomplish at the meeting and of how you are going to deliver your message.

You will get the most out of this module if you have read Module 4, Build an Investment Proposal, and Module 5, Identify Potential Investors, as the information presented in this module refers to the contents of those two modules.

The case example at the end of the module illustrates the importance of meeting potential investors. If you have been following the New Tech Distributors Corp. (New Tech) example, then you are familiar with New Tech's background. This module shows how New Tech goes about preparing to meet and meeting potential investors.

This module covers six topics.

1. **The process of getting materials to potential investors.** What are the most effective ways of getting your investment proposal and other materials to your potential investor? What are the advantages and disadvantages of each?

2. **Preparing to meet a potential investor.** What should be the objectives of the first meeting with your potential investor? How can you make a strong first impression?

3. **How to present your investment proposal.** What should you focus on when presenting your investment proposal? How much detail should you include?

4. **Understanding the due diligence review.** What is the due diligence review? What is high-level due diligence?

5. **Presenting your opportunity — understanding and appealing to investors' needs.** How should you keep a prospective investor interested in your business venture? Why is it important to pay attention to your investor's needs and respond effectively to questions during the meeting?

6. **What to expect and how to conduct yourself during the initial meeting.** How should you conduct yourself during the first meeting? How can you raise the level of investor confidence in your ability to manage your business and realize the objectives and strategies outlined in your investment proposal?

Details

1. The Process of Getting Materials to Potential Investors

Before approaching potential investors, you should identify and select the most appropriate candidates, that is, those who are most compatible with your industry and your business as discussed in Module 5, Identify Potential Investors. In particular, Table 5.1 in Module 5 demonstrates how to go about selecting the most suitable investors based on specific criteria.

The module indicated that you have a greater chance of success in raising financing from risk capital investors if certain criteria are met.

The investor is located in your geographical area. Most investors prefer being close to the company they invest in. Travel time is generally not productive time, and active, hard-working investors are not interested in wasting their time.

The investor is familiar with your industry. An investor with a working knowledge of your particular industry is able to better evaluate the inherent risks in your business venture, and may be in a better position to advise you on important business-related matters. Often, the most difficult obstacle for an investor to overcome is understanding the industry factors that might hinder the realization of his or her investment.

The investor has a favourable first impression of you and your business. The importance of starting a good and healthy relationship should be emphasized. Prospective investors are often called on to analyse many investment proposals and have a limited amount of time and funds. You must, therefore, quickly convince your investor that your business venture is worth his or her time and effort, and that there is an excellent possibility for a long-lasting and mutually beneficial relationship.

The investor has a reasonable level of business and financial knowledge that will help him or her understand the implications of investing in your business venture. The more business and industry-related experience the prospective investor has, the better the chances are for an effective and sustainable association. If your company's products and the industry you operate in are compatible with your potential investor's interests, the more effective you will be in getting your message across. You will be able to establish a good working relationship and benefit from the investor's industry-related knowledge and contacts.

Making Initial Contact with Potential Investors

As covered in Module 5, potential investors have different priorities and want to invest in specific industries and companies. It is important to remember that risk capital investors have certain preferences about companies they want to champion. These preferences are usually based on the type, history and status of the company and the amount of financing needed.

Once you pinpoint investor priorities and needs, the next step is to determine how to contact them:

- through a meeting in a social/industry setting (the chance meeting);
- by introduction through a respected intermediary;

- by sending a formal introductory letter; or
- by making a "cold call" via the telephone.

It should be noted that there are various legal and regulatory implications that influence the method and number of potential investors you may want to contact. Refer to the sections on legal and regulatory implications in the Build an Investment Proposal and Identify Potential Investors modules for information on these topics.

Meeting Potential Investors in a Social/Industry Setting

Social gatherings, industry-based meetings or cocktail parties, including industry association-sponsored events, investment forums and keynote speaker addresses, are excellent opportunities to meet potential investors and lay a solid foundation for initiating a relationship. If you are faced with such an opportunity, a few guidelines should be followed in order to help cement that relationship.

- Entertain a general discussion with the potential investor to ascertain whether he or she is in the capital investment business. Many individuals are interested in listening to ideas and concepts; however, few may actually be "authentic" investors. It is important to determine this at the outset so time is not wasted.
- Provide the investor with a brief overview of your company and its prospects, and mention that you might be interested in attracting private investment capital.
- Exchange business cards.
- Following the meeting, you may send a summary of your proposed business venture (this summary may be drawn from your investment proposal or you may produce a document for that specific purpose) attached to a letter. Indicate in the letter that you will be contacting him or her in a few days for a follow-up discussion, and to answer any questions about your project. (For more information on preparing your investment proposal and executive summary, refer to Module 4, Build an Investment Proposal.)
- Follow up the letter with a telephone call. At this point, the potential investor has had an opportunity to find out about you, your company and your industry. A brief telephone conversation should give you some idea of the merit of pursuing further this particular investor.
- When speaking directly to a potential investor, the inflection and general tone of the conversation can help you decide on whether the person has a legitimate interest in pursuing your business opportunity. If you have to leave a voice mail, your message should be brief, to the point, positive, non-threatening, and you should indicate a specific time when you will be calling again.

Remember, you are trying to establish a foundation for further discussions. The importance of making a favourable first impression should be emphasized.

It is crucial not to dominate the time of a prospective investor nor to leave an impression of trying to "trap" the investor into a relationship with your company. This initial contact should be warm, cordial and non-threatening; you do not want to intimidate your potential investor before the two of you have a chance to meet in a more formal way. All you want to accomplish is to lay the foundation for a future meeting; to leave the person with a positive and favourable impression about you and your company.

Introduction Through a Respected Intermediary

Generally, the most likelihood for initiating a business relationship will take place through the involvement of a respected intermediary. This intermediary is someone who has established a good relationship with both the risk capital investor and the entrepreneur. The major advantage of an intermediary is that this individual has proven credibility and integrity that is respected by both parties.

These individuals can be instrumental in bringing investment proposals to potential investors. Risk capital investors rely heavily on networks of bankers and accountants for referrals concerning potentially promising investment proposals.

Among the most common intermediaries are:

- friends;
- accountants;
- bankers;
- lawyers; and
- other entrepreneurs.

While this is considered the most effective approach for initiating an investor-entrepreneur relationship, it is important not to abuse the relationship you already have with your intermediary by putting him or her in an embarrassing situation. It is important for your intermediary to embrace, in an unconditional and convincing way, your investment proposal. This way, your intermediary will actively and sincerely support your project, and be able to sell it to contacts. Remember, you are asking the intermediary for a favour; it is important to respect that relationship and not to tarnish it.

Financial advisors (accountants and financial professionals) are another source of potential intermediaries. These individuals are often well connected and have established a network of clients and contacts with private investors.

Sending a Formal Introductory Letter

Another way to make contact with investors is to send a letter giving an overview of your business intentions. This letter may include the executive summary contained in your investment proposal. Several guidelines should be kept in mind when using this approach.

- The introductory letter must be concise, well presented and written in a manner that will capture the attention and interest of your potential investor. If you don't have the ability to draft a letter that has a professional look and contains just the right type of information, you might consider using professional assistance. Remember, this letter may become the basis for subsequent discussions; it must make a favourable impression and attract your investor's attention and interest.
- The introductory letter must inform a potential investor about you, your business and your project without overloading the reader with irrelevant and abundant details. It should summarize your investment opportunity, just enough to raise his or her curiosity and interest. It should be good enough to incite the prospective investor to ask you for more details and subsequently, a follow-up meeting. If the letter is too drawn out, poorly organized, or not compelling enough, your chances for a follow-up telephone conversation and a meeting will be diminished.
- The introductory letter should emphasize the unique characteristics of your investment opportunity. It should focus on your company's products and services and its position in the marketplace, and provide an overview of key members of your management team, emphasizing their strengths, competencies and related industry experience.

Making a Cold Call via the Telephone

The cold call is another way to contact a potential investor. This approach can also narrow down the field of potential investors; however, it is considered somewhat ineffective. Cold calls occasionally can bring about favourable responses, but more often than not, they bring cold responses.

If you are successful in speaking to the targeted individual or representative, it is imperative that your introduction be as brief as possible, well structured and organized and, most important, that you project a positive attitude about your investment intentions. The time to catch the potential investor's interest is very short!

Here are a few steps that should help you maximize the potential of a cold call.

- Introduce yourself and determine whether the person has the time to provide you with a few minutes.
- Give the potential investor an overview (speaking in a calm and positive manner) of your company and its potential for future growth.
- Allow the potential investor to ask questions. It is important not to be defensive about inquisitive and penetrating questions. Remember, your potential investor knows little or nothing about you and your company at this point. Questions are usually a good indication that the potential investor is interested in learning more about your business venture.
- Ask for a meeting. Potential investors may not wish to meet with you until they have examined the details of your business venture. This is normal and you should be prepared to respond quickly to requests for additional materials (i.e. an introductory or follow-up letter with the executive summary of your investment proposal). The amount of material you forward depends largely on the level of interest of the potential investor during the first contact. At the very least, make sure you provide the potential investor with your name (spell it, if it is not distinguishable) and telephone number.
- If you are able to arrange a meeting, make sure the investor receives background materials about your business venture well ahead of the meeting. As discussed previously, many potential investors want to review documents before a meeting. This is not unusual and is a good sign since it suggests that the risk capital investor is interested in your business venture.

The primary advantage of a cold call over an introductory letter is that you have at least established personal contact and a more solid foundation for a follow-up meeting. Also, this gives the potential investor the opportunity to review your material. The cold call can also help you weed out risk capital investors who are not likely to be serious about your project. This increases the time you have for the more serious prospects.

If you are going to make a cold call, it is important to focus clearly on the information you want to convey. While it may not be advisable to have a written script, it would be advantageous to have a written outline of the key points you want to cover.

Because of the limitations of the telephone as a medium, you have to make an extra effort to convey a high level of self-confidence, composure, enthusiasm and business knowledge. Often, when someone is using the cold call approach, it can be very excruciating. It is sometimes more difficult to maintain your composure and to speak at a normal speed and volume. Nervousness can cause individuals to try to explain many things in too short a period. Be aware of this; if you do not deal with it appropriately, your potential investor may think negatively about you and your investment opportunity.

To summarize, the most effective way to approach a potential investor is through an intermediary. You should make a serious effort to get an introduction of some sort before sending your investment proposal to a potential investor. Therefore, your task is not only to target specific risk capital investors, but also to find appropriate individuals to make the necessary preliminary introductions. That way, when the investment proposal reaches the risk capital investor, your chances of having it read (instead of being discarded) are greater.

2. Preparing to Meet a Potential Investor

After many months of preparation, writing your investment proposal and contacting risk capital investors, imagine receiving a telephone call from one of the investor groups and hearing, "We're interested and we would like to meet with you tomorrow." What is now required is an effective presentation to reinforce the potential investor's initial interest, ensure that things move along smoothly and, more important, gain momentum toward the desired conclusion.

You must now make sure you present your business and management team favourably and honestly, using facts and projections that will withstand careful scrutiny. There are several things to do before your first meeting: plan it carefully, review your investment proposal one more time and, most important, rehearse your presentation (several times if needed). When a potential investor calls for a meeting, it is the first indication that your investment proposal has accomplished its primary mission. You must now make your investment proposal come alive.

Importance of the First Meeting

The first meeting is the most important for setting the stage for a prosperous and long-term relationship. As mentioned in Module 4, Build an Investment Proposal, the first several minutes that risk capital investors spend reading your investment proposal may be the most important minutes. Equally important are the 30 or 40 minutes you will have to present your proposal.

While this meeting may take place informally, you should keep in mind the old saying, "You never have a second chance to make a good first impression." The first meeting usually sets the tone for subsequent get-togethers. If this meeting does not go well, it is difficult to regain the potential investor's attention and interest. You should, therefore, make every effort to come to the meeting well prepared, enthusiastic and aware of the potential investor's objectives, needs and perspectives. However, this is not a one-way street. Another key objective of your first meeting is to determine if there is a mutual "fit" between you and your potential investor. To achieve long-term success, a relationship has to work both ways.

Objectives and Tone of the First Meeting

This first meeting is usually informal and involves a small group of individuals: you and your advisors (if required), and your potential investor and his or her advisors (if needed). This meeting is usually characterized as a "feeling out session"; both parties make an effort to assess the likelihood and benefits of establishing an ongoing relationship.

- Is the chemistry between the parties genuine? How well will you be able to work together? Does the partnership arrangement manifest itself for a good and long-lasting relationship?
- Does the risk capital investor plan to take an active or passive role in the management of your company? Entrepreneurs and investors sometimes have very different perspectives on the degree of ongoing involvement.
- Does the investor believe your financial projections? Are they reasonable? Sometimes, an experienced investor will be able to give you a great deal of perspective on what private investors want in terms of acceptable risks, required returns, valuation, amount of financing available, financing terms and potential exit strategies.
- Has the potential investor requested additional information? The investor may already be interested in obtaining more information before proceeding to the next stage, and may want to read it before a follow-up meeting.

- Does the investor understand your requirements? No matter how obvious and comprehensive your investment proposal may be to you, on occasion, potential investors may not have a clear understanding of your specific requirements, and the initial meeting is a way to provide clarification and additional explanations.
- Does the investor have access to the type and amount of capital you believe is needed to fund your project? It is only through a clear dialogue that you will be able to assess properly whether the investor shares the same views related to your requirements, and has the necessary resources to match them.
- Has the potential investor the experience with small businesses, the management synergy and additional resources to help your business improve its operating and financial performance? These synergies may include:
    - having industry knowledge and general business experience;
    - having a network that will help you get acquainted with other important business contacts including other investors (playing the role of an intermediary); and
    - providing other perspectives on your business (i.e. someone to talk about the challenges, opportunities and threats facing your business; someone who can ask pertinent questions that will make you discover opportunities and advantages, and strike at the root of a problem, not just at its visible symptoms; someone who has an interest in your business and can objectively provide you with serious advice on important decisions and projects).

During the meeting and throughout your discussions with your potential investor and his or her advisors, you should be sensitive to body language. For evaluating the degree of success of a meeting, you may want to observe key signs, such as:

- the nature of the questions asked (whether they are pertinent);
- the enthusiasm and voice intonation;
- positive eye contact;
- active note taking; and
- posture (whether the sitting posture suggests a legitimate interest).

3. How to Present Your Investment Proposal

Your written investment proposal will pass the first step if it is complete, clear and readable; if the product has intuitive value; if there is a clear difference between your business venture and the competition; and if it deals with a product, industry and investment level that the risk capital investor likes.

The meeting with your targeted investor is much more than a detailed presentation of your firm, your product and your management team. It is an exploratory session in which the potential investor will want to know how you think, how you solve problems, how you deal with others and much more. He or she will ask questions that will put pressure on you to see how you react. During the meeting, the investor will be looking for two things: your belief in yourself and in your product or service, and your credibility and integrity.

As mentioned before, it is important to forward a copy of your investment proposal to the investor in advance of the initial meeting. A well-presented document promotes a much better focus during the meeting. If the investor has the necessary background information, you will be able to proceed with your presentation at a more rapid and decisive pace. Also, if the investor has done his or her preliminary scrutiny of your proposal, the meeting will zero in on areas of particular interest and concern to the investor. If this is the case, you will not be required to go over your entire investment proposal; the meeting would, therefore, focus on providing additional details and clarification of interest to the risk capital investor.

You should not be irritated by questions the investor may ask about certain aspects of your investment proposal. You may want to use the analogy of a salesperson and customer: *The sale begins when the customer starts to ask questions!* Also, this is an arm's length process where both parties want to protect their interests.

Often, the potential investor may be interested in what makes your company successful and will want to zoom in on your firm's strengths and weaknesses. You must expect discussion of some of the weaknesses of your project and should be prepared to respond to questions effectively and address the issues that seem to concern the investor. It is important not to bluff your way through the answers; if the investor raises an issue you are not sure about, acknowledge the merits of the comment and indicate that you will follow up and come back with an answer at the next meeting.

When organizing the initial meeting, ask the investor if he or she has any particular issues that should be covered. The investor may ask for additional information before your next get-together or may want you to address specific issues during the meeting.

You should plan to respond adequately to any contingencies. For instance, the prospective investor may not have had a chance to review the details of your investment proposal before the meeting; if this is the case, plan your presentation accordingly to ensure that the objective of the meeting is realized.

Don't forget that all top performances are well rehearsed. Good rehearsals help you smooth out your presentation, eliminate the rough spots and even make you feel more confident about your abilities as a presenter.

It is important to make a presentation that is error free. It is critical for you to know the content of your investment proposal; the investor is part of a closely knit community and word of a clumsy and inarticulate presentation gets around quickly.

Here is a list of principles that may help you improve the organization of a first meeting, impress your potential investor and be successful.

- Prepare an agenda or outline describing the most important points you plan to cover during the meeting.
- Ensure that you and your colleagues will be on time for the meeting.
- Assess the potential investor's time constraints and make sure they are respected.
- Maintain your enthusiasm and project a high level of confidence in your outlook about your business venture during the entire presentation.
- Ensure that your presentation focusses on the potential investor's needs, particularly in terms of:
  - the amount of funds you will require;
  - how you will be using the funds;
  - the financial return expected from the investment;
  - the inherent risks related to your proposed venture;
  - the possible exit strategies (when and how the investor could expect to realize a return on the investment);

- the competency and credibility of the members of your management team;
- your products/services and their growth and profit potential;
- the size of your target market and justification for growth potential (focus on what would cause the investor to believe your assumptions are reasonable);
- your position in the marketplace and your competition;
- the investor's likely day-to-day involvement in your business;
- what makes your company unique and distinctive, and gives you a competitive advantage; and
- the obstacles or threats your business faces (to show you are realistic about the future and to enhance your credibility).

These are the most important elements to be taken into account when presenting your investment proposal to a prospective investor. For more information on this material, refer to Module 2, Demonstrate Your Investment Potential.

Unless it is requested by the investor, do not give too much technical detail on your products or services. Occasionally, the investor or advisors may go off on a tangent, no matter how focussed your presentation may be. Although it is important to respond to their queries, you should be candid and forthright by skilfully doing everything to avoid getting bogged down in unimportant details. Never lose sight of the key objectives of your meeting.

Avoid the use of industry-related jargon unless you believe the audience is knowledgeable about the industry you are involved in. Some entrepreneurs are so absorbed in their industry that they feel everyone at the meeting will have a common understanding of the market, industry and products in question. It is important to always speak at the level of knowledge of your audience.

After the meeting, take a few moments to assess how successful (or unsuccessful) you were. A checklist will guide you through an after-the-fact analysis of the meeting and help you pinpoint the weaknesses in your investment proposal. Write down any concerns the potential investor raised so that next time you will be prepared to address them in a more effective way.

You might want to have someone at the meeting take notes of the issues and comments for a follow-up and an assessment of the meeting. You should ask for this person's comments as soon as possible after the meeting. Being candid and unbiased is essential and should be welcomed by you, not challenged. This person may be an advisor or a trusted member of your management team.

Here are typical questions you might want to ask the assessor:

- Was the investment proposal clearly written?
- Were there any important points missing in the investment proposal? What about the presentation itself?
- Was the investment proposal credible? Were the data and assumptions believable?
- Did the management team make a good impression? Was the chemistry apparent?
- Did the market appear to be large enough? Did it appear to be real?
- Did the investor appear to be interested in the product? In the industry?
- Were the financial projections and analysis presented thoroughly?
- Were the strategies and plans realistic in terms of the goals contained in the investment proposal?

Often, investors who have read your investment proposal and listened to your presentation may make invaluable suggestions in terms of improving your proposal and dealings with other investors. Irrespective of the outcome of the meeting, you should seriously consider their advice. Each meeting is a learning experience. If a particular investor decides not to invest in your business, think about getting his or her feedback. Their suggestions may help you take corrective action, improve your investment proposal and make a more effective presentation.

4. Understanding the Due Diligence Review

If you were successful with the initial meeting, you should now be prepared to move forward to start negotiating the terms of the contract. However, before making the cash investment into your business, your investor will want to investigate the details of your investment opportunity; this is done through the due diligence review. The due diligence review has two objectives. First, it convinces the investor that the business venture described in the investment proposal is real and credible and that the plans are sound and realistic. Second, it can be used by the investor to help prove (if needed), during a subsequent lawsuit, that all reasonable steps were taken to determine that the investment was sound.

What Is the Due Diligence Review?

The due diligence review can be defined as the fact-finding process that knowledgeable investors perform before making an investment. There are several levels to the due diligence review associated with the investment process. These levels range from the high-level due diligence review at the front end, to the very detailed due diligence review that takes place as you close the deal. For a further discussion on the detailed due diligence review within the context of closing the deal, refer to Module 8, Close the Deal.

The high-level due diligence review takes place within the context of the initial meeting. It usually takes the following elements into consideration.

Questions based on discussions and/or materials received before the meeting. Normally, potential investors will undertake a preliminary evaluation of the materials to determine whether the investment is worth pursuing. For example, they:

- may perform a financial analysis to review your company's historical performance to compare it to meaningful industry norms or benchmarks; or
- may consider questions to be discussed with you during a subsequent meeting.

References. A potential investor may request specific references such as customers, suppliers and bankers. From the investor's perspective, this is a quick and inexpensive way to add substance to your written materials and to confirm your credibility.

Tour of your facilities. This is essential in obtaining an understanding of your business and of how you go about managing your operations. If possible, and when necessary, arrange relevant demonstrations of your product(s). An experienced investor will benefit from a tour by seeing, first-hand:

- evidence of activity levels throughout your plant;
- indications of excess or obsolete inventory;
- general upkeep of your facilities and equipment maintenance practices;

- size and make-up of your labour force; and
- indications of operating efficiencies or inefficiencies (e.g. plant layout).

Credit bureau reports. It is a normal part of the preliminary due diligence review to obtain credit bureau reports (e.g. Dun & Bradstreet/Creditel, etc.). Potential investors may not use the reports to evaluate your worthiness. However, they may use them to ensure the consistency of the information that is included in your investment proposal.

Management team and individual track records. Your investor will want to get specific information about you and the members of your management team regarding education, experience, specialized skills and age. The investor may ask for this information if it was not provided in your investment proposal.

> Some investors prefer to make surprise visits during the financing process to ensure that the employees are not just "acting" while visitors are on-site. While you should encourage your employees to welcome visitors, exaggerated behaviour is easily spotted and may suggest that the day-to-day behaviour is a hidden reality. Ensure that your business is ready for such a visit at any time during the due diligence review.

For more information about management capabilities that prospective investors are looking for, refer to Module 3, Demonstrate Your Management Capabilities.

Financial track record. Investors will often want to review copies of your company's annual financial statements. Normally, they will analyse the last three to five years (if available) prepared by your public accountants (e.g. audit or review reports). As an alternative or in addition to these reports, they may want to examine the financial statements filed with your corporate income tax returns for the same periods as well as other supporting internal financial documents.

Details underlying the data and assumptions used to make the financial forecasts in the proposal. Here are some of the questions you should expect from your investor about the information contained in your investment proposal:

- Is the projected growth in revenue and profit reasonable in comparison to historical, industry and general economic performance? If not, are there market studies or other information to justify your financial projections?
- Are management's explanations for variances between historic performance and projected results illusive? Do they make business sense?
- Is management being reasonably conservative with the planning assumptions?
- Has management considered the financial effects if the projections are not realized? Have contingency plans or "what-if" scenarios been prepared?
- Does your company have the capability in terms of facilities and people to accommodate the projected sustainable sales growth?

Note: A common error many companies make is to assume a linear relationship between growth in revenues and the expenses incurred to earn the revenues. This may be appropriate, particularly for the short term, but often, expenses over the longer term do not follow such a predictable fashion.

The due diligence review is a normal and integral part of an investment transaction. The degree, timing and approach may vary significantly among potential investors. However, the following should be taken into consideration if you are faced with questions and requests from potential investors:

- Maintain your composure. This is key. Understand comments from your investor's point of view and do your utmost to respond on a timely basis, with candour and honesty.
- Recognize that the intensity of the due diligence review has to do with the depth of experience and expertise of the investor regarding a particular industry. Typically, the more an investor wants to know about your business venture, the higher the investor's interest in expending more energy on the due diligence review.

5. Presenting Your Opportunity — Understanding and Appealing to Investor Needs

Throughout the negotiating process, and particularly during the initial meeting, you must be able to convince your investor of the merits of your company's vision and investment potential. Also, you will need to demonstrate that your management team has the ability to implement successfully the strategies and plans described in your investment proposal. The initial meeting is a fundamental part of the process, and goes a long way toward establishing credibility with your investor. When presenting your business opportunity, it is important to respond to the needs of your investor.

The following are a few guidelines that emphasize, to some extent, what was covered previously. You should keep them in mind if you want to be successful in the initial meeting and effectively address the needs of your investor.

- First and foremost, you must demonstrate confidence, and be persuasive and enthusiastic. Potential investors want to invest in companies with a solid and motivated leadership.
- Be sensitive and understand your potential investor's perspective. Always try to understand the concerns and issues of investors as they review your material and meet with you. For example, they may consider the points listed in Table 6.1, What to Present to Potential Investors to Catch Their Attention.
- Do not be evasive. If you do not know the answer to a particular question, make a commitment that you will get the answer. Do not be hazy or fuzzy about your answers. Your personal credibility and reputation are of the utmost importance; they are your most valuable assets.
- You must demonstrate that the level of risk of your investment opportunity makes good business sense and adequately supports the expected financial return.
- Make sure you gear your answers to your investor's needs. This is fundamental to the entire exercise. Remember, potential investors are trying to evaluate you and your company to determine if there is a good fit with their criteria when selecting an investment opportunity.

Table 6.1: What to Present to Potential Investors to Catch Their Attention

Who are you?	• Are you the type of individual I want to do business with? • Do I believe you are competent, credible and a person of integrity? • Do you have the requisite personal skills to guide the company's growth and implement its strategic plan?
What is your track record?	• What have you done with the company to date? • What is your track record with other projects or companies? • Do you have experience in the market you want to take the company into?
What is your commitment?	• Will you continue to have significant financial commitment to the company? One of the reasons some companies pursue new investors is to fund the buyout of the existing owner. Potential investors often find this disconcerting. Frequently, one of the key things an investor is buying is you and your capabilities as a successful entrepreneur. In other words, you are often the magic.
Do you have a solid management team and, if so, who is in charge of what and why?	• An investor will want to ensure that all the important areas are covered: sales/marketing, production/research and development, and finance/administration. • Are the individuals occupying these positions competent and experienced? • What are their individual track records? • What is the basis for the executive compensation packages? • Is the size of management excessive for the size, complexity and growth potential of the business? • If you are an older individual, is there a succession plan for a new generation to take over your responsibilities? Are there other individuals within your company who can assume increasing responsibilities?
Were the assumptions used to project revenue growth reasonable?	• Can you justify your assumptions? • Are they consistent with historical trends? • Have you considered various scenarios? • Is the growth reasonable in relation to what is happening in the industry? • Is it reasonable when comparing it to the state of the economy or industry?
Does your company have a competitive advantage?	• Is technology a barrier to other companies that might want to enter your market? • Is there copyright or patent protection? • Do you have a unique position in the market or within the industry? • What differentiates your company or products from your competition?
Is there a viable exit strategy for this investment?	• What are the implications of your proposed exit strategy? • Are there other available exit options? How viable are these options?
How will the financing strategy influence the business strategy?	• How will the investor's funds be used? • Will the additional investment assist the company's growth? • Has the investment been considered in the various projections and forecasts you have presented? • Are other investors being approached?

6. What to Expect and How to Conduct Yourself During the Initial Meeting

This section focusses on how to maximize the impact of your presentation during the initial meeting. In addition to having the right information available and anticipating the potential investor's questions, you should consider the following.

Dress appropriately for the occasion. While you may not regularly wear business attire to perform your day-to-day activities, you should dress appropriately. The key is to make your audience comfortable and to dress in a business-like and professional manner.

Be prepared. You should be comfortable with the material you will be presenting. Rehearse in front of others (e.g. members of your management team, trusted advisors or associates) before you present your material to your targeted investor. Consider the following points:

- At the beginning of the meeting, make sure all members of your management team are appropriately introduced.
- Present an overview of your business venture.
- Suggest a tour of your facilities before getting into the details of your investment proposal. It helps investors to better understand your business and the products or services you are selling.
- Have others on your team assist you if you cannot comfortably respond to some of the questions. While you might be very strong technically, you may need the assistance of your controller or sales manager to explain the details of your financial projections, etc.
- Make sure the room is comfortable, quiet and of an adequate size for the number of people that will be present at your meeting.
- Ensure that the group is not interrupted. You may wish to consider an off-premise location if your facilities are not adequate.

Be prepared to go into the details on any portion of your investment proposal. Depending on the size of the group, it may be appropriate to show overheads or at least distribute handouts on the key components of your presentation.

- While it is important to fulfil all reasonable requests, you should be aware of the audience as a whole. If the meeting appears to bog down in details, it may be preferable to deal with a particular matter that appears complex and time consuming closer to the end of the meeting.

Be honest and forthright. You want to retain the investor's attention. Therefore, it is important for the relationship and for credibility that you answer all questions honestly, adequately and fairly.

Maintain your composure and patience. Remember that you have been intimately involved with your business for many years. Sometimes, the potential investor may ask questions that are difficult and show a lack of understanding. It is important that you maintain your composure and do your utmost to respond to the questions in a calm and poised manner, and that you do not talk down to the investor.

7. Conclusion

In this module, you looked at:

- how to get to that first meeting and present your investment proposal to a targeted investor;
- how to prepare for your first meeting with an investor;
- what is involved in the preliminary due diligence review;
- what level of detail to present to an investor during the first meeting and how to catch his or her attention; and
- how to conduct yourself during your first meeting.

Remember, there may not be a comfortable fit between you and the first investor you meet. The process takes time and patience. In the next module, you will be taking one of the more challenging steps as you Negotiate the Deal. You will investigate how to prepare for and conduct negotiations with investors.

Case Example

This case example allows you to follow a fictitious company, New Tech Distributors Corp. (New Tech), as it seeks risk capital to finance its growth. The case shows how New Tech addresses the key elements presented in the Details *section of each module.*

If you have not already done so, read about New Tech's background and the challenges it faces in the earlier modules. As well, you may wish to refer to the Steps to Growth Capital Overview for an introduction to the overall structure of this program.

New Tech has arranged a meeting with one of the potential identified in Module 5. Read about what New Tech does to prepare for the meeting with the investor and how the meeting progresses. You should refer to the Details *section of this module for more information related to this subject.*

The Dress Rehearsal

Grant Agent (New Tech's financial advisor) arrives at 9 a.m. to meet with the company's management team for a dress rehearsal for the first investor meeting with Walter Buffet (potential investor). Grant points out to Stuart Chip (New Tech's CEO) and Elizabeth Pratt (New Tech's accountant) the importance of preparing for the meeting. All members of the management team who were involved in the preparation of the investment proposal will be meeting Buffet.

Buffet requested a copy of New Tech's investment proposal in advance of the meeting. He is to meet with them at New Tech's offices. He also requests an agenda and a tour of the plant and office premises.

Grant starts the dress rehearsal by telling the team that there is no second chance to make a good first impression. An important element of the first meeting is to establish a good rapport with the potential investor. He also indicates that if Buffet has read the proposal thoroughly, as he typically does, he will likely ask questions randomly to the team members. The questions will cover various topics with the members of the management team.

Grant reviews the types of questions Buffet is likely to ask. He will probably want to discuss New Tech's competitive advantage, the size of the market, and why the company thinks it has the ability to achieve rapid and sustained growth. The assumptions underlying the financial forecast would likely be a serious topic of discussion. The management team should also expect probing questions about its track record, including a discussion of the valuation and exit strategy.

Grant says Buffet should expect to be questioned on whether he plans to take an active or passive role, and what he means by the term "active." Stuart wants to know how long Buffet intends to be in the investment business and what his position is regarding follow-on investments (additional investments made by existing investors). For example, if New Tech wanted to make an acquisition and needed money quickly, a follow-on investment could be required. Stuart will also ask Buffet what role he has taken in other business ventures and their outcomes. Grant says this is perfectly acceptable and recommends that questions for Buffet be written down in advance by all team members. Not all the questions have to be asked at the meeting, but it does encourage a dialogue.

The Meeting

Buffet arrives on schedule. Stuart invites him into the boardroom and introduces him to Elizabeth. Grant is also present. Buffet asks if he could be given the plant tour before the meeting begins. Elizabeth tries to find Kevin Matley (New Tech's production manager) to accompany Stuart and Buffet on the tour. There is a five minute delay before Kevin is located.

After the tour, the management group assembles and the meeting goes very much as Grant predicted. However, it is apparent that Stuart is not very familiar with the assumptions in the financial forecasts and Elizabeth has to respond continually to the questions. The speaker phone in the room is connected with New Tech's paging system and during their discussion, they are continually interrupted. Stuart finally pulls the phone jack. Buffet asks for a copy of the full EconTechData report. He also asks Stuart for personal and business references.

Toward the end of the meeting, Buffet asks what percentage of the company they are offering in exchange for $600,000, explaining it is a critical piece of the puzzle to ensure the two parties are not wasting their time. Elizabeth responds that they do not have a precise figure since they expect the market to determine the price. Buffet says it is too preliminary for him to make a value judgment, but on the basis that they meet their forecasts, if they are thinking it is worth more than $2,500,000, then he is out. Stuart says pricing is not the only criteria for making the investor selection. There are many qualitative factors but the number he quoted is not out of line with New Tech's thinking.

Grant provides each member of the management team with a post-meeting checklist, which he asks them to complete individually. He then compares the results, which are quite consistent among the team members — a good sign. Next, he asks the team what they learned from this session to help them in subsequent meetings with other investors. Several observations are made in terms of the additional preparation they could have done, how they should have had Kevin standing by when Buffet arrived and how they could have used overhead slides to illustrate various financial points.

Grant arranges additional meetings with other investors but the management team always comes back to Buffet as the favourite. The team does not want all its eggs in one basket, so the members decide to also continue discussions with Chinook, the second choice. They have three meetings with Buffet and Chinook, and both indicate they would be presenting term sheets to the company at the next meeting.

Author's Note:

All of New Tech's preparations to date have led to this moment. New Tech has met the investors and is prepared to enter the final stages of negotiation. New Tech has learned:

- *the importance of involving the management team in preparing for that important first meeting with the investor;*
- *the importance of conducting a preliminary due diligence review (before an investor conducts a formal due diligence review later on during negotiations);*
- *to practise or walk through the first meeting or presentation;*
- *to anticipate questions and the issues the investor will probe;*
- *to anticipate and plan all details from the time the meeting starts until the meeting ends;*
- *to be prepared to negotiate at the meeting; investors do not want to waste time;*

- ***to follow up the meeting with a management team debriefing and discussion about how the team could improve things; and***
- ***to consider several investors to obtain the best fit.***

Myths

The private investors' market is predominately made up of unsophisticated individuals.

On the contrary, while this group generally may not have a sophisticated financial analysis background, it often has significant experience with other private investments. These investors generally exhibit significant business acumen based on years of experience.

Private investors will make their decisions of whether or not to invest based primarily on a company's historical financial performance.

Most investors focus their attention on the company's current financial position and your ability as a manager to drive the business forward. You are often the "magic" they are looking for to realize their opportunities.

The meeting with a potential investor should be casual and very little preparation is required.

The reality is that this meeting is usually important to the final decision. It is crucial to be well prepared and conversant with all aspects of your operation and your presentation. You should have a sound grasp of what your message is and how you are going to deliver it to the potential investor.

Frequently Asked Questions (FAQs)

How much preparation is required before meeting with a potential investor?

As is often the case, the answer depends on the amount of leg work that has been done before the meeting. Generally, you should:

- plan what your message should be;
- have a clear plan of how you are going to deliver your message; and
- organize who, from your management team, will be present and what parts, if any, each will present.

Does the potential investor usually come to the first meeting alone?

It depends on how sophisticated the potential investor is and on the nature of the investment being sought. It is not unusual for potential investors to bring along a financial advisor such as their own public accountant.

What types of questions can I expect at the meeting?

Most investors come to the meeting having done their homework and, generally, have identified your company's weaknesses. Therefore, it is just as important that you come to the meeting prepared to address, in a logical and honest manner, any weaknesses you have identified.

Should I prepare an agenda for the preliminary meeting?

This is a good idea even if it is used for nothing more than an outline to help you ensure that you are being conscientious and organized. If the meeting only involves two people, you and the prospective investor, handing out an agenda may not be appropriate. In this case, the agenda could be used as an outline.

If an investor receives written materials before the meeting, should I ask if there is anything in particular the investor wants to cover during the meeting?

Most definitely; it is natural for you to phone and confirm details for the meeting. This is an opportunity for you to ask questions and will help you prepare reasoned and comprehensive answers in advance of your meeting. As well, this will assist you in keeping the meeting moving. Remember, the investor's objective is not to ambush you but rather to ensure that the investment meets the particular tolerance for risk the investor has established.

Module 7: Negotiate the Deal

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Executive Summary

If the investor is impressed by your investment proposal, feels comfortable about your management's capabilities, and has demonstrated a serious interest in investing in your business through past meetings or preliminary requests for further information, and you believe there is a chance a strong, long-term financial relationship can be struck, the next step involves negotiating the deal.

Negotiations can be complex and require some sophistication. You may wish to retain the services of an experienced negotiator to facilitate this process on your behalf. Although both parties have a strong incentive to arrive at a win-win solution, the negotiations may still begin with opposing positions, which must move toward closing the gaps and making a deal. As an entrepreneur, your opening position may be documented in your investment proposal. (It may be either stated explicitly or implied through your financing requirements.) Investors will then provide (verbally or in writing) the parameters of what they are willing to offer you, and negotiations will begin.

The central purpose of negotiating is to find a solution that will satisfy the needs of both parties. Potential investors have specific needs that must be met before they invest in your business. In earlier modules, you have identified your own needs. You must now negotiate an arrangement with which you and the investor are both comfortable. This is not a simple process. Typically, negotiations are complex, requiring significant and sophisticated negotiating skills. This module will give you some assistance in developing a plan and identifying proven negotiating tactics in preparing you for this important stage in the acquisition of risk capital. Learning a few simple skills can turn an impasse into a deal, save you money and get your business moving.

> Negotiations can be painstaking, lengthy and sometimes stressful for both parties. However, with effective planning, they can be made more bearable and will proceed more smoothly. You need to know what to expect and should understand the finer issues associated with negotiation strategies in order to reach a final agreement.

You can go through this program in two ways. You may want to read the details of the module to get a conceptual view related to identifying potential investors. Or, you may want to read the case example at the end of the module to learn how to apply some of the concepts and techniques presented in the module. However, the learning process will be enhanced if both approaches are used simultaneously.

The case example illustrates the concepts involved in negotiating a deal. If you've been following the New Tech Distributors Corp. (New Tech) example, then you are familiar with New Tech's background. In this module, you can follow New Tech as it negotiates the deal.

This module covers seven topics.

1. **Preparing for negotiations.** What are the needs of the typical investor? How do you prepare for negotiations in the investment process? What are the essential elements of a negotiation plan?

2. **Steps in determining and evaluating alternative deals or solutions.** What is the process for determining alternative deals? Risk capital arrangements come in many forms. These steps will assist you in achieving an agreement that meets your needs.

3. **Valuation issues related to competitive offers and the type of investor making the offer.** What are the key valuation issues? What factors may influence the terms of your deal?

4. **Understanding key elements of typical entrepreneur/investment arrangements.** What are the key elements of a typical entrepreneur/investor arrangement? What are the items you will be negotiating? The world of risk capital employs its own language and jargon. Some common terms and their meanings are included in this section.

5. **Understanding the key elements of a shareholders agreement.** What makes an effective shareholders agreement? How should it be prepared?

6. **Key legal issues related to the deal.** What types of legal issues might arise during negotiations toward an agreement?

7. **Negotiating pitfalls and best practices.** What are the most common pitfalls? This section will describe some of the more frequent mistakes and best practices in risk capital negotiations.

Details

1. Preparing for Negotiations

If you and your investment proposal have survived the intensive scrutiny described in the previous modules, negotiation is the starting point for drafting your financial and equity package. If you have suggested a form for the deal in your investment proposal, it may be ignored in favour of some other method of operating preferred by the investor. The next several sections cover the key points to get you ready to negotiate your financial deal successfully.

Negotiating Risk Capital Arrangements

Before you meet the investor to begin negotiations, you must do your homework. You should develop a negotiation plan that maps out your position on various financing issues, such as profit sharing and ownership participation. You can then discuss, and obtain a consensus on, these positions with your management team and advisors (if applicable), and understand the impact of your position before meeting with the investor. You should consider several options, which can be presented to the investor in order to achieve common ground.

There are no general rules for the final negotiation process. Every investor has unique objectives. An intermediary known and trusted by the investor often facilitates the negotiations, and, as the entrepreneur, you should consider retaining your own advisor. You may be too close to the matter to concentrate on the important issues, whereas your advisor should pay specific attention to all aspects of the negotiations. The investor's facilitator will be familiar with the process and you should be represented by an equally competent agent with negotiating experience.

During this phase, consult your legal counsel on how he or she wants to, or should, be involved. Counsel may suggest that you and the potential investor develop a common language agreement first and then have him or her develop the appropriate legal documentation.

There are many different ways to structure a transaction with an investor. Each transaction is different. There is no cookie-cutter approach to fit all circumstances. The structure will have to meet your objectives and those of the investor. For example, different financing alternatives may generate specific tax implications, which you should discuss in detail with your financial and legal advisors. Ensure that you are thoroughly briefed and conversant with the various structural alternatives and their implications.

The financing structure you incorporate into your investment proposal will vary, depending on the mix of conventional and risk financing involved. The Identify Your Financial Needs module assisted you in assessing your financial needs and analysing financing alternatives. It also examined the impact of the investor's needs, goals and constraints on the financing, and helped you identify the type(s) of financing arrangements that best suit your requirements. In the Build an Investment Proposal module, you incorporated your preferred financing structure into your investment proposal. You may want to review this information as you prepare to negotiate with the investor.

The focus of this module is to discuss an approach to the negotiations, assuming you are willing to sell an investor an interest in your business.

In earlier meetings with the investor, you may have reached consensus on a number of issues. For instance, you may have agreed on the amount of investment your company requires. However, there are several other significant matters that will require negotiation. Before finalizing your negotiating position, you should reflect on the meetings you have had so far and try to understand the needs and motivations of the investor. You should try to separate the people from the problem to allow both parties to focus on the objectives of the investment process. The immediate goal is to produce a mutually satisfactory agreement and to develop a lasting financial relationship. Continuously ask yourself the questions why and why not, in relation to the investor's point of view.

Typically, the investor's primary needs are:

- the likelihood of an adequate rate of return;
- a capable management team;
- a sound business opportunity;
- reasonable protection against unexpected developments (downside protection); and
- exit strategies.

Likelihood of an Adequate Rate of Return

Investors invariably look for a rate of return on their investment that is commensurate with the level of risk they associate with the investment opportunity. This rate may vary with the structure of the investment (debt or equity), the nature of the business opportunity and the investor's individual cost of funds. However, it is not unusual for an investor to look for a rate of return, over a period of three to five years, in the range of 25% to 40% per year on an equity investment, at a minimum. These expectations are driven by the substantial risks associated with private equity, such as high rates of business failure, long periods before capital is returned to investors, inability to control operations and the low liquidity of investments.

> **Always do your own calculations and sensitivity analysis before negotiating with the investor. This will provide you with your own numbers to compare to the rate calculated by the investor and enable you to show the investor you have based your proposal on reasonable assumptions that carry a higher probability of success.**

You can help mitigate investor concerns in this area by demonstrating a high likelihood you will achieve your goals and objectives. You should remember equity investments carry little cost to your company. The investor typically reaps the reward through the sale of the investment to a third party. Even though you are giving up some equity, the value of your shares in your company may be much greater than it would have been had you not sought the investment.

Capable Management Team

Confidence in the ability of your management team to achieve its objectives is one of the most important concerns of investors, assuming the rate of return on the deal meets their expectations. No matter how good your product or service may be, it will not be successful if your management team does not have the ability to accomplish goals effectively in achieving profitability. You must be open and candid with investors and expect to meet with them many times until they are confident you can be trusted with their money. You may want to review the Demonstrate Your Management Capabilities module to ensure you are fully prepared.

Sound Business Opportunity

Your investment proposal, which you have developed previously, should demonstrate the feasibility of your project in a clear and concise manner. Since investors do not have unlimited resources, they must evaluate potential investments quickly. Proposals that do not show immediate potential are set aside or quickly rejected. This allows the investor to concentrate only on those proposals that clearly demonstrate sound business opportunities. (You may wish to refer to the discussion in the Identify Potential Investors module.) The typical investor is not a philanthropist, but a businessperson seeking to optimize the benefits he or she receives from available resources. To maximize the probability of success, it is only reasonable to expect investors to consider only sound business opportunities.

You would not be preparing for the negotiation stage if your investment proposal did not demonstrate a sound business opportunity to at least one investor. However, you cannot rely entirely on the investment proposal to convince the investor that your business represents the best available investment opportunity. To improve your odds of receiving risk capital, you should be able to expand on the material you have provided to the investor. You may find it useful to put yourself in the investor's position and ask yourself: "What do I need to be convinced that this proposal represents the best possible opportunity for my investment?"

Reasonable Protection against Unexpected Developments (Downside Protection)

Most investors want the option of having a seat on your board of directors. This will provide them with some influence over the strategic direction of your company. They may also want to approve certain material matters, such as capital expenditures over a certain dollar amount or the hiring of key executives. Some investors may want the deal structured so they can take action to protect their investment if your company does not meet the financial objectives described in the business plan. The investor may require conversion privileges on convertible preferred share or debenture issues which, if exercised, enable the investor to obtain control over your company and install new management. You should not deem the investor's requirements unusual. Consider the investor's need to minimize exposure to risk. These options help to manage risk and offer the investor an opportunity to take action (when and if necessary) to protect against unexpected developments and downside risks.

Exit Strategies

All investors want to know how they will recover their original capital. It is important to discuss the optimal terms of the investment for both parties. In addition, you will need to ensure that the timing of the investor's planned exit from the investment accommodates your company's needs. Investors often expect to hold their investment for three to seven years. Your negotiation plan must include a mechanism for the investor to recover his or her capital and achieve the required rate of return.

Exit mechanisms on equity investments can take several forms:

- The sale of the investor's share in your company to a third party. (This is not the sale of the entire company, but only the shares held by the investor. This can be difficult to structure up front, as selling an illiquid minority interest can be a challenge.)

- The sale of your company.
- Equity buyback. (This can be complex because your company may have to finance the buyback and base it on a pre-agreed valuation formula.)
- An initial public offering (IPO).

Do not assume the investor expects to remain involved with your company until you are in a position to offer shares to the general public. Only a very small number of companies eventually go public. At the same time, all investors will want to realize cash on their investments at some point in the future. Remember, you may need to be flexible on exit mechanisms because the investor may have an alternative need for the capital in the future.

Ask your investor for the names of several current and former investee entrepreneurs. Speak with these people to gain a sense of the investor's style and preferences. This information will give you a better idea of how to deal with the investor and allow you to formulate alternatives that will be mutually acceptable.

The Identify Your Financial Needs module described various types of investment and the exit strategies associated with different investment structures. Although entrepreneurs often see the demands of investors as unreasonable, it is important to remember that not all investment structures require payment from the internal resources of the investee. Some structures, such as debt instruments, redeemable preferred shares, buybacks or "puts," may require repayment from internally generated funds. However, other risk capital investment structures, such as common shares, allow the investor to recover the investment, and achieve the required rate of return on the basis of an increase in the value of the business (which may be realized through a sale of the shares to a third party).

Earlier modules suggested that you should consider the investor as a partner equally dedicated to the success of your enterprise. In cases where the investment structure provides an exit strategy that allows the investor to recover the investment from outside sources, there is virtually no cost of risk capital to your business (other than opportunity costs), since the market will pay the high cost of that risk capital over time. The investor's demands for high rates of return on an investment do not necessarily mean you will be required to make a payment from internal funds. The negotiation process will proceed much more smoothly if you and your advisors are aware of the various investment structures and related exit strategies discussed in the Identify Your Financial Needs module.

Once you have reviewed the investor's needs and have determined the implications of various investment structures (and their related exit strategies) on your business, you should analyse and review the potential impact of several qualitative and quantitative matters with your management team. This will ensure your team agrees with the position you will be taking. Some of these issues are described below.

Profit Sharing

If the deal structure is based on a participation fee or other profit sharing arrangement, you should consider how future profits will be allocated between you and the investor. For example, you may be able to negotiate an incentive that increases your share of future profits if you exceed preset profitability thresholds by placing a cap or ceiling on the total fee paid. (However, do not be surprised if the investor asks for a floor or minimum fee amount.)

Ownership Participation

In the Demonstrate Your Investment Potential module, you established your valuation parameters when you determined the maximum amount of ownership you would be willing to give up in exchange for the capital you require. It is important to remember that potential investors will base their ownership requirements on their perception of the risk associated with your proposal. You will probably find you are prepared to give up a smaller percentage of your company than the investor is seeking. However, this should not mean you cannot reach agreement on this issue. Be flexible. There are alternative strategies that may provide the opportunity to earn back a portion of the investor's share of your company before the scheduled exit date. For example, you may be able to negotiate an option to buy back a part of the investor's shares if your company exceeds its financial targets at certain points in the term of the investment. Agreement on the extent of ownership participation and alternative exit strategies is important to the success of your negotiations.

If you are not completely comfortable with your valuation parameters or if you wish to review your position on ownership participation now, you may wish to return to the Demonstrate Your Investment Potential module.

> Ask yourself whether you prefer to own 70% of a potentially bigger company in five years by giving up a 30% interest now, or retain 100% of a much smaller company that may be restrained by insufficient capital.

Titles and Job Descriptions

In the Demonstrate Your Management Capabilities module, you prepared formal job descriptions, résumés and biographies for each member of your management team. These documents should have been included with your investment proposal.

Individual Management Team Members' Commitment to the Business

It is important that you recognize exactly how much time and effort your management team will be required to spend on the business. Most investors expect a 100% commitment to the project from every member of your management team. This is an important issue in the investment decision, if not the most important. If you are planning to devote less than 100% of your effort to your business, you are telling the investor your team lacks commitment. The implication is your proposal may carry hidden risks that are not addressed in your presentation materials. Remember, you are trying to establish a partnership based on mutual trust. If the investor suspects you have not been totally honest, your credibility will suffer, and your entire proposal may be questioned. If you are unable to commit 100% of your effort to your business, you should explain your reasons for reduced participation. However, you should also be prepared for the investor to back away from the deal without further discussion.

> Ensure your management team is totally committed to the project. Do not expect the investor to inject risk capital if you are not prepared to devote yourselves completely to the success of the business.

Current Shareholders Agreement

Review your current shareholders agreement in detail. Look for possible conflicts or issues that may arise if a new shareholder is added. Be sure to obtain legal advice to ensure you are fully aware of potential limitations, such as restrictions on the issuance of additional shares, payment of dividends, etc.

You should also discuss other housekeeping matters with your legal counsel, such as ensuring your records and filing are up to date. You will find a further description of shareholders agreements in Section 5 of this module, *Understanding the Key Elements of a Shareholders Agreement*.

Planning for Negotiations

As part of your negotiation plan, you should define what is important to you.

- Establish your goals and the underlying principles and objectives. This process will allow you to keep the discussion focussed on objective criteria instead of emotions and personalities.
- Your goals should be flexible. Identify goals that are essential and items that you are willing to give up to achieve a deal. Your main objective is to achieve a deal, not to win each and every point.
- Establish the essential elements, including your opening position, your bottom line and acceptable compromises.
- Consider issues other than just money. You should review issues such as control of the business over time, the value added by the investor, expanding the board of directors to include other outside directors, etc.
- Once you have defined your goals, compare them with the investor's needs. Think of alternatives for goals on which you may appear to differ.

At this point, discuss the goals you have defined with your advisors. You need to make sure your goals are reasonable and you are adequately prepared to participate in the negotiation process.

Inherently, negotiations for risk capital arrangements are aimed toward agreement on a win-win solution, as evidenced by the following:

- Both you and the investor share a mutual interest in completing a financing deal. You need capital to grow your business, while the investor needs to place capital where it will earn a good return. The problem of finding a common ground where both of those goals are attainable is at the centre of the negotiation. Remain focussed on this issue and be flexible in negotiating to achieve this end. The worst outcome is when no agreement is reached on a deal that could have been good for both parties.
- Attempt to establish a longer-term relationship with the investor. Consider the investor as a partner who will further your business aims, not an adversary to be beaten.
- Wherever possible, you should base your positions on objective criteria. For example, when negotiating the timing of the receipt of funds, set one of your criteria as the timing indicated by a cash flow model with mutually acceptable assumptions. This will eliminate the need to bargain over minor points, such as timing discrepancies between your need for all the money at the outset and the investor's desire to inject funds over three years. Both parties will be able to understand the objective criteria, and neither will lose face by accepting a compromise from the original position.

It is important to invest adequate planning time into the process. Negotiations are not simple exercises; they require some sophistication and skill. You should ensure you have prepared appropriate documentation before entering the negotiation meeting, and both you and your advisor should have copies of all documents, which might include:

- the negotiation plan;
- notes on previous discussions with the investor;
- data used in your investment proposal;
- information on the investor; and
- an outline of your total proposal.

2. Steps in Determining and Evaluating Alternative Deals or Solutions

Now that you have planned your negotiations strategy, the next phase is to determine the steps in evaluating the alternative deals or solutions to help you achieve an agreement that meets your needs. This process involves five steps.

Accept the fact that you will not achieve everything to your complete satisfaction. In any negotiation, each party has to give up something in order to reach an agreement. Some examples of concessions you may have to consider are:

- giving up more control than you planned;
- accepting less capital than originally expected;
- providing more information, more frequently to the investor (monitoring); and
- allowing the investor to review (and perhaps approve) your strategic plans and capital expenditures.

Identify potential issues in advance. Based on your knowledge of the investor and his or her needs, identify issues that will be of greatest concern. Remember, your success in raising the required risk capital relies on your willingness to accommodate the investor's needs. In a win-win situation, the final agreement will include concessions on both sides. While you might have to give up certain positions, you may find the investor is also prepared to concede on other points. If you are able to rank the investor's needs and to identify positions that you are prepared to alter before negotiations, it can be helpful when formulating your alternatives. It is important to remember that every position you take has an alternative that may achieve the objectives desired by both parties. Nothing is cast in stone at this point.

Develop objective criteria to help resolve these issues. To get agreement on issues where you and the investor differ, you need to develop objective criteria to measure the impact of each of your goals. For example, basing the investor's board representation at a level equal to the percentage of equity provided demonstrates how you might use objective criteria to accommodate the investor's need for monitoring and your need to keep control.

Prepare a second best solution. Before you start the actual negotiations, meet with your management team and financial advisors to identify acceptable alternatives to your opening position and to the investor's needs as identified above. These alternatives should be based on objective criteria and should reflect your understanding of the investor's needs. Rank the acceptability of each alternative and establish a set of solutions that will still accomplish your goals while respecting the investor's position.

Know your bottom line. Determine, in advance, which elements of the deal are important to the success of your opportunity. These elements will represent your bottom line and may prove to be "deal breakers." However, it is important to remain open-minded to possible alternatives. During the negotiations, the investor may bump up against one of your essential elements. However, the effect may be offset by concessions in other areas. For example, you may state you are not willing to give up more than a 30% interest, while the investor insists on 40%. If the investor is willing to make other concessions, such as allowing you the opportunity to earn back the additional 10% if you exceed your income projections by a predetermined percentage within a fixed time frame, you may be prepared to give up the higher percentage initially. Remain focussed on the issues and be prepared to propose objective alternatives based on the second best solutions you identified earlier.

3. Valuation Issues Related to Competitive Offers and the Type of Investor Making the Offer

In the Demonstrate Your Investment Potential module, you determined the value of your existing business and established what you are prepared to give up to the investor in exchange for the investment you are requesting. You may have decided not to reveal this value to the investor before the negotiation stage and, therefore, may not have included the valuation in your investment proposal. For the purposes of the following sections of this module, this value is referred to as your asking price.

Disclosing Your Asking Price

At some point in the investment process, it may be appropriate to disclose your asking price to potential investors. This decision should be considered carefully. Some entrepreneurs include their asking price in the investment proposal, which effectively means setting a price ceiling. Unsophisticated investors (e.g. local angel investors without extensive investing experience) may not know how to price the investment appropriately. They may be relying on you to demonstrate leadership in this exercise. Disclosing your asking price will assist unsophisticated investors in the calculation of the expected return on the proposed investment.

On the other hand, if you are dealing with sophisticated investors whose only business is making investments in companies, it might be advisable *not* to indicate your price. These experienced investors should have the expertise to value your business and could arrive at a higher value than you anticipated. In addition, if you have approached a number of interested investors, you should try not to disclose your asking price until you see what they offer. Whether you disclose your price or not, is a matter of debate. The correct answer for you depends on the number and nature of the interested investors.

If you disclose your asking price, you must be able to support the price in a rational and convincing manner. In most cases, you would not share your detailed value calculations with investors. Rather, investors should be provided with summary value calculations, a description of the valuation methodology adopted, and the key considerations and assumptions you made in arriving at the value of your company. It may be useful to provide the investor with a summary of alternative calculations that indicate the sensitivity of your conclusions to changes in key variables and assumptions. In addition, if you have been able to find information related to transactions involving potentially comparable companies that supports your value determination, this information should be shared with potential investors, again in summary form.

Investors Will Determine Price

Although you may have a high level of confidence in the value you have placed on your business, the market will ultimately determine its value.

The value of your business will be established as you negotiate offers with investors. Each potential investor will have a different valuation based on his or her particular perception of future risks to your business and derived returns. You should be aware that price is not always equal to value due to differences in:

- the investor's level of knowledge of your company's strengths, weaknesses, opportunities and threats;
- differences in various investors' desire to participate; and
- each party's negotiating strengths.

Different types of investors may value your business differently according to various factors, such as their expected rate of return, industry knowledge or perception of your management team. Increasing investor knowledge of your business, industry and management team will reduce the potential uncertainty and, therefore, should help to increase the asking price.

Investors most familiar with your business, your management and the industry in which you operate may be willing to pay higher prices.

Be aware of the state of the market. The supply and demand relationship of investment opportunities will also affect pricing. In addition, you should consider the investor's motivation to place money at this point in time and whether other investments are being considered.

Valuation is an important part of the negotiating process. However, valuing your business is not a simple process. Ensure that you seek the services of a financial advisor who has experience as a business valuator. Try to be realistic and objective in your determination of the value of your business. An overly optimistic approach may result in your rejection of a reasonable offer. Alternatively, an overly conservative approach may result in a settlement at less than the maximum possible price.

It is important to know how the market values your business, because it is the market that will ultimately determine its value. Information on investor pricing methodology and other key considerations may be obtained through discussions with investors with interests in similar businesses and with the investors with whom you are negotiating. Increased knowledge of investor pricing methodology and key considerations will allow you to formulate and negotiate a strategy to maximize your proceeds at minimal cost.

Generally, any element that lowers the perceived risk to the investor will increase the value of your business to that investor and decrease your ultimate cost of funds. It is important to remember:

- the right information provided on a timely basis will reduce the investor uncertainty and perceived risk; and
- the flow of information to the investor should continue through the negotiation process.

Comparison of Alternative Offers

In most cases, you can expect to receive cash in exchange for a percentage of the common share equity of your company. In some cases, investors may want a portion of their investment to include preferred shares or subordinated debt. In addition, other elements such as a "ratchet clause," which adjusts the percentage equity received by the investor over time based on certain performance objectives, may be required by some investors. Where the investor's offer includes instruments other than simple common share equity, a comparison of alternative offers is an important but difficult task. For comparative purposes, all offers should be converted to their cash equivalency (the equivalent amount of cash received today). Non-cash components of offers may include:

- various forms of equity, near equity and non-equity instruments;
- a ratchet clause or other mechanisms to adjust equity participation from time to time;
- buyback rights based on predetermined prices or formulas; and
- staged payment terms.

In addition to these quantitative factors, a comparison of offers should consider the following questions:

Investor resources. Will the potential investor bring other benefits, such as management expertise, business contacts, other business opportunities and the opportunity for further investment to your company?

Investor personality. Will you be comfortable dealing with this person?

Agreement on Price

Under all circumstances, you and your shareholder group should reach agreement on the range of pricing you consider acceptable. At some point in the negotiation process, most investors want to know whether or not they are wasting their time. They will want to determine if your views on pricing are so far apart that an agreement on price is not realistic.

Reaching agreement on price can be very difficult, but there are ways to bridge the gap, a ratchet clause being a common method. The underlying principle of a ratchet clause is that the entrepreneur will earn back a percentage of equity if certain targets are met and, likewise, will give up additional equity if targets are missed. Care must be taken in establishing the components of a ratchet clause to ensure the target is objective and measurable. In addition, you should establish how the calculation will be affected by unusual income or expense items that may occur over the measurement period. The targets are often measured based on cumulative results over a predefined period. Due to potential tax consequences and the sophistication of this type of financing structure, you should seek professional advice if you are considering the inclusion of a ratchet clause in your financing agreement.

It is important to remember that the deal you make on this round of financing will have an impact on the next round. Don't forget, when building a business, you may have to seek financing more than once as you grow. As a result, you should ensure any agreements or contracts related to the current investment do not overly reduce your flexibility in terms of future investment. You should consider each investor's willingness and ability to invest additional funds.

4. Understanding Key Elements of Typical Entrepreneur/Investment Arrangements

Now that you have gone through the valuation issues related to competitive offers and the type of investor making the offer, the next phase is understanding the key elements of the negotiation process for your final agreement with the investor. These key issues revolve around:

- control;
- performance objectives;
- exit options;
- anti-dilution provisions;
- employee contracts;
- the board of directors; and
- the term sheet.

Control

Until now, you have probably enjoyed 100% control over your business. You have made all the decisions to invest in equipment, lease new premises, develop new products, set financial budgets, etc. Relinquishing part of this control may be the hardest issue to resolve in your own mind. Remember to keep focussed on the deal, and work with the investor as you both attempt to develop a lasting partnership.

Most investors are not looking to gain control of your business. After all, they do not have the time to run all their investee companies. Investors want to achieve an acceptable rate of return while limiting their risk, and may impose restrictions on your ability to enter into certain arrangements, such as raising additional debt equity, capital expenditures above a certain dollar amount, increasing management salaries, repaying shareholder loans or hiring new managers without consultation. As described in the previous section, there are certain performance-based mechanisms, such as ratchet clauses, that may result in an adjustment to the amount of equity you give up.

Performance Objectives

As noted above, you can negotiate an option to buy back equity (or give more up) as certain performance objectives are met (or not met). Performance objectives may include:

- total sales volume targets;
- gross margin dollars and percentage targets;
- net income targets;
- cash flow levels; and
- debt repayments.

It is important that you and the investor agree on the performance objectives used to determine your level of success. This agreement is reached on the base levels for each objective at the outset.

Exit Options

Your investor will want to have a clear exit strategy. Investors state one of the key reasons for turning down proposals is the lack of exit provision contained in the agreement. You should be able to provide feasible alternatives.

Generally, investors use one of the following exit mechanisms:

- sale of the investor's interest to a third party;
- sale of your company;
- buyback agreements;
- initial public offering; or
- debt repayment.

Sale of the Investor's Interest to a Third Party

Minority investments in private companies are very difficult to sell due to the lack of control and liquidity. The process of bringing in a third party to replace an existing investor is very similar to your current search for capital. There will be significant costs in finding new investors, and the process may consume a great deal of time and effort on the part of company management and the investor. The process may be complicated even more if the new investor questions the current investor's motives for exiting. The person may think, "If this company is such a good prospect, why sell out?" For these reasons, sale of an investor's minority interest to a third party is not a common exit option. However, a shareholders agreement may contain a clause called a "put option." An investor can "put" shares to the entrepreneur (requiring them to be repurchased at a price based on a predetermined formula) in the event your company does not go public in five years, for example, or can sell the shares to a third party if you cannot buy the investor out.

Sale of Your Company

The outright sale of your company may be easier to accomplish than the sale of a minority investor's interest. This assumes you are in agreement with the circumstances under which your company would be sold. The sale of your company can take time, and the investment agreement should allow for this eventuality. The sale would likely require the use of a third-party advisor, and the selection of such an advisor, or agent, should be agreed to at the outset.

Buyback Agreements

This exit strategy is used occasionally by investors. The principal notion is that the future cash flow of the business should enable you to pay back the investment over time. The buyback may take the form of a put option held by the investor, as described previously. The price of those shares will normally yield a significant return to the investor. Usually, cash flow performance targets must be met before the buyback because of the need to take cash out of the business. It may be necessary for your company to obtain a new source of financing in order to bear the cost of a forced redemption of shares of this type. Accordingly, you should seek professional advice before entering into any agreement that carries this type of exit mechanism.

Initial Public Offering

This exit method can be the most satisfying to both you and your investor. Depending on market conditions and the nature of your business, the value of your company's shares can be very favourable when compared to your original invested capital. Normally, the initial public offering (IPO) will allow both you and the investor to withdraw some capital while increasing the liquidity of your remaining shares.

While there are certain benefits associated with an IPO, there are also some negative considerations when evaluating alternative exit strategies.

- The loss of a significant portion of your ownership position leaves you in a minority position.
- Your business becomes public, which forces you to share potentially sensitive information with the public.
- A portion of your shares will be held in escrow, possibly for years, thereby forcing you to remain invested.
- Frequently, for an IPO to be successful, all the money raised must be used to expand the business. Your new shareholders will want to see a plan to increase the value of their shares and may not be interested in simply providing immediate cash for you or your risk capital investor to withdraw.

Debt Repayment

This mechanism is common if the financing structure used by the investor includes subordinated debt with specific repayment terms. Subordinated debt may have equity "kickers" or participation fee features, both of which are discussed in the Identify Your Financial Needs and Demonstrate Your Investment Potential modules. In addition, certain subordinated debt instruments may carry conversion privileges which allow the investor to convert the debt into a predetermined number of common shares under certain circumstances, such as your company's inability to make scheduled payments of principal or interest. You should consult with your financial advisor before entering into any financing arrangements which include convertible term preferred debentures or similar debt instruments.

Anti-dilution Provisions

Anti-dilution provisions are a common feature of financing arrangements. They may take two common forms:

- a prohibition against the sale of additional shares to maintain the investor's current equity position; or
- a provision allowing early investors to participate in future sales of equity in order to maintain their current ownership percentages.

The latter form is preferable to most entrepreneurs because it gives them flexibility to raise additional capital if necessary.

Employment Contracts

It is always a good idea to include employment contracts for you and your key management employees as part of the financing agreement. The contracts should clearly set out the expectations of both parties. Legal advice is strongly recommended in drafting the employment contract. A few common terms of a typical employment contract are:

- remuneration, including benefits and the form of compensation;
- termination arrangements, including conditions, notice period and severance;
- conditions attached to the voluntary departure of the individual from your company;
- a form of "non-compete" contract, which restricts the individual from starting a similar business or working for a competitor in close proximity for a specified period of time; and
- ownership of technology or intellectual property (if applicable).

Board of Directors

The board of directors should consist of individuals who are able to assist your business by providing experience, advice, skills and contacts. A great deal of thought and energy should be devoted to your search for board members possessing these qualities.

Your investor may or may not want a seat on the board depending on factors such as preference, the relative size of the investment and the current board composition.

Try to include as many outside board members as possible. Some of the advantages of having outsiders are:

- objectivity;
- contacts and networking opportunities; and
- credibility to financiers.

> Try to avoid appointing family members to your board of directors, especially if they are not directly involved in your company's operations. You can lose credibility if they are perceived as a rubber stamp for your decisions. As well, you may lose the opportunity to add skills and experience to your company.

Term Sheet

The term sheet is an outline of the major points in an agreement. An investor will probably want to negotiate a large number of matters, but assuming your investment proposal was comprehensive and the various meetings with the investor have been fruitful, the investor should be willing to issue a term sheet for discussion purposes at an interim point in the negotiations. Some investors will only issue term sheets if they are very serious about considering an investment and have completed some of the high-level due diligence review. Others may be prepared to issue a term sheet at a preliminary stage in order to get their cards on the table and establish an agenda.

The term sheet typically provides all or some of the following elements:

- total investment;
- equity investment;
- loan component;
- class of shares;
- percentage of total equity of company to be acquired;
- dividends and dividend priority;
- components of shareholders agreement;
- debenture or security agreement, subscription amount, interest rate and how calculable and payable, term of loan, principal repayment, representations and warranties, reporting and events of default;
- payment of expenses and fees;
- condition precedent to completion;
- no material adverse change in the affairs of your company;

- completion of audited financing statements; and
- lapse date of closing.[1]

You should treat the term sheet very seriously. You may go through several drafts with the investor during your negotiations. You should also involve your legal counsel in the review of the term sheet because it forms the basis for the legal documentation.

5. Understanding the Key Elements of a Shareholders Agreement

Now that you have gone through the process that leads to the key elements of a typical entrepreneur/investor arrangement, the next critical step has to do with the preparation of the shareholders agreement.

Shareholders Agreement

If your company does not currently have a shareholders agreement, you will need to have one prepared to accommodate the new equity investor. The shareholders agreement establishes the rights of shareholders and the duties and powers of the board of directors and management. In addition, the shareholders agreement may provide existing shareholders with the right to approve future shareholders. Typically, some items contained in a shareholders agreement might:

- establish rights related to the sale, issuance or subsequent distribution of shares, including rights of first refusal, piggyback rights and pre-emptive rights;
- define the rights and duties of the managers;
- stipulate options to buy or sell the shares (i.e. a "shotgun clause");
- anticipate what will happen in case of death, retirement, etc., of a shareholder (the agreement should indicate whether the value of the shares relative to these events is to be calculated pursuant to a predetermined formula and if the minority position of the shares in question should be considered); and
- establish the composition and duties of the board of directors.

If an exit mechanism has been negotiated for shareholders, it should also be documented in the shareholders arrangement.

As with any contract, legal assistance is essential for your own protection. Because of different circumstances for each business relationship, a standard or off-the-shelf shareholders agreement will not likely be appropriate to your circumstances. A custom agreement will have to be crafted to fit your specific needs and arrangements. An effective agreement cannot be prepared without the help of an expert.

It is important that the shareholders agreement clearly documents the intentions of the shareholders. Relationships among shareholders can and do change. Intentions and facts that are clearly agreed to by shareholders today may become areas of future dispute if they are not properly documented.

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[1] Torkin, Manes, Cohen and Arbus, "Legal Components of Venture Capital Financing" a presentation by Mr. Barry S. Arbus, Q.C., February 13, 1997.

Debenture or Security Agreement

If an investor makes a subordinated debt investment in your business, there will generally be a requirement for a debenture or security agreement. Key elements of the agreement may include:

- principal amount;
- interest rate;
- term of loan;
- principal repayment;
- security;
- financial covenants;
- activities requiring investor's consent; and
- reporting.[2]

6. Key Legal Issues Related to the Deal

You should not attempt to undertake the formal structuring, drafting and review of the shareholder agreement and the lending agreement yourself. These documents are important to the financing arrangements and may affect your company for years to come. You are also responsible for taking steps to ensure the transaction is conducted in compliance with any applicable federal and provincial securities laws. You should seek competent, experienced legal assistance.

7. Negotiating Pitfalls and Best Practices

Frequently made mistakes in risk capital negotiations include:

- poor or inadequate preparation;
- asking for unrealistic terms at the outset, which affects your credibility;
- playing with the truth and underestimating the other party's abilities to perform the due diligence review;
- unrealistic expectations about your product's sales potential (investors refer to this situation as "hockey stick" growth expectations where a graph of sales growth versus time looks like a hockey stick);
- being too accommodating to the other party just to close a deal (be prepared to walk away from an unfavourable deal);
- ignoring or not trying to understand the other party's position and needs;
- failing to listen carefully to the other party, resulting in you assuming an issue is resolved when it is not (this will cause friction later in the negotiation when the issue resurfaces, and may result in your inability to close the transaction);
- establishing a position that will be impossible for you to back away from without losing face (for example, by refusing to give up more than 20% of your company, your flexibility is severely compromised, and sticking to such a rigid position may not give either party enough room to arrive at a mutual agreement);

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[2] Torkin, Manes, Cohen and Arbus, "Legal Components of Venture Capital Financing" a presentation by Mr. Barry S. Arbus, Q.C., February 13, 1997.

- beginning negotiations too soon or before the other party's interest and understanding of your opportunity is fully developed; and
- assuming you have no leverage (remember, the other party would not be there unless he or she could gain by doing business with you).

You will be asked to document your growth assumptions in detail by providing market size, market penetration and the infrastructure required to attain these projections. Each aspect will be challenged by the investor. Therefore, you must establish your credibility from the outset or run the risk of not being taken seriously.

Best Practices in Risk Capital Negotiations

The following are some best practices in negotiating risk capital agreements:

- Put in the time to prepare. Investigate the other party as much as possible and know your own position thoroughly.
- Prepare detailed alternatives and try to determine what the other party's alternatives might be.
- Know your material well. Understand your bottom line on all major issues.
- Use an advisor. This will give objectivity to the negotiation and remove some of the emotional reactions and the potential for a battle of wills between the two parties. An advisor can facilitate the negotiations by keeping the focus on objectives and criteria (win-win) and avoid deadlock positions (win-lose). You can also benefit from the advisor's negotiating experience.
- Understand your own concessions and why you made them. Are your criteria appropriate?
- Control your emotions, perceptions and the way you express your ideas, needs and observations. Negotiation is fundamentally a game of human relations.
- Relax and remain objective. Remember, the worst outcome is when no deal is achieved and you need to start your search for another investor. This is better than accepting a poor deal, which will impair your chances of success or cost you control of your company.

8. Conclusion

In this module, you looked at:

- preparing for negotiations, taking into consideration the specific needs of the investor;
- the process and steps in investigating alternative deals;
- when and how to disclose your asking price;
- key elements of typical investment arrangements and the shareholders agreement;
- some legal considerations; and
- some common negotiating pitfalls and best practices.

In the next module, you will Close the Deal with your investor by investigating how to reach a mutually agreed upon deal, performing the final due diligence review and looking at some tips in managing your new relationship now that you have struck a deal. This is not the end of your journey, however. In many respects, this is the beginning of a whole new phase in the life of your business.

Case Example

This case example allows you to follow a fictitious company, New Tech Distributors Corp. (New Tech), as it seeks risk capital to finance its growth. The case shows how New Tech addresses the key elements presented in the Details *section of each module.*

If you have not already done so, read about New Tech's background and the challenges it faces in the earlier modules. As well, you may wish to refer to the Steps to Growth Capital Overview for an introduction to the overall structure of this program.

As a result of meeting potential investors, New Tech has received two term sheets from different investors. Read about how New Tech prepares for and completes negotiations with one investor. You should refer to the Details *section of this module for more information related to this subject. Specifically, you should review the results of the negotiations documented in the final term sheet (see p. 22).*

The Offers

Term sheets from Walter Buffet and Chinook Ventures (potential investors) arrive by fax the same day. Elizabeth Pratt (New Tech's accountant) immediately makes copies for all the team members, and faxes one to Grant Agent (New Tech's financial advisor) in Toronto and another to Tony Lee of Smith & Smith, New Tech's lawyers. She wants the negotiations with Buffet to include outsiders to make the process more objective. She arranges a conference call among the management team, Grant and Tony. Buffet's deal is clearly superior, as Chinook wants 49% of the company with more stringent terms and conditions. More important, the team members believe that Buffet could be of greater assistance to New Tech. They then decide to focus on Buffet's term sheet. He is prepared to invest $600,000 for 44% of the company.

Grant warns team members that they are not going to get everything they ask for. They should focus on being flexible and not view the exercise as win-lose but win-win. The key question is: "When you put it all together, is it a good package?" It is important to establish New Tech's bottom line, acceptable compromises and opening position.

There are several items in the term sheet that the team wants to negotiate.

- Buffet wants to nominate three members to the New Tech Board of Directors. The team understands that board positions are one way for Buffet to stay informed, but New Tech currently has only three board members and Stuart Chip (New Tech's CEO) does not want to give up control. Tony agrees, suggesting that Stuart propose to restructure the Board with two seats as an opening position. Stuart's mother and brother are currently the other two board members. Tony suggests that Stuart consider appointing two non-family members, which Buffet may agree to. Stuart says his bottom line is that he retains control of the Board.
- Buffet wants approval power over any capital expenditures greater than $25,000. Again, the team understands that Buffet wants to be sure that New Tech does not spend the new funds on large capital items without his approval. However, many of New Tech's expenditures are between $25,000 and $50,000, so this would be cumbersome. Elizabeth expresses the most concern about this point. However, after a spirited discussion, it is agreed to live with it.

- Buffet wants prior approval on a number of items, including expenditures, and requests 30 days to give his approval. The team feels this time requirement is impractical. Elizabeth thinks five days to approve items is sufficient, but Stuart points out that one working week is a little harsh since Buffet might be travelling. Elizabeth says her bottom line is 15 days. Tony suggests that in his experience with other deals, 10 days is typical. The team decides 10 days is the opening position with a fallback to 15 days.
- The team sees Buffet's 44% ownership proposal as his opening position and wants to decrease the percentage during negotiations. From the valuation work Grant and New Tech have done, it appears 40% is more reasonable. Stuart thinks that, in the context of the entire deal, a 4% differential should not be a deal breaker either way. However, he is willing to compromise. Grant suggests that tabling the valuation methodology might be an objective way to reach 40%, as perhaps Buffet was using different assumptions. The team agrees.
- Buffet wants an employee option plan put in place before closing. Tony says this would delay closing for several weeks while the legal documentation was put in place. Stuart expresses his agreement in principal to the employee option plan, which he has previously discussed with Buffet, but thinks the time frame is unreasonable. He suggests it be delayed for a year. Elizabeth doubts Buffet would wait that long, since he has indicated how important it is to have employee participation. Stuart says he could live with six months.
- Regarding exit strategy, the term sheet calls for New Tech to commit to going public by the year 2002. The team is concerned that this would be a mistake if IPO market conditions were not right. But yet the members realize that any investor would want a clear exit strategy. Tony recommends a clause that would make going public subject to various considerations, such as factors relating to New Tech's business, financial market conditions and valuation. The team agrees, and Elizabeth asks Tony to draft the clause.

The Deal

Grant recommends that he, Stuart and Elizabeth meet with Buffet to negotiate the terms of the deal. As expected, they discuss, compromise and finally reach a conclusion after several hours of negotiation. Elizabeth tells Stuart afterward that, in her view, the fact that they had planned the negotiation made all the difference. She believes Buffet found them to be flexible and co-operative, and that when it came to pricing, Buffet was won over by the extent of the team's preparation.

The results of the negotiation can be seen in the final term sheet (following). Tony indicates what an important milestone it was to reach agreement on the term sheet. It also forms the basis for drafting the shareholders agreement.

Stuart is surprised at how many closing documents there are. The shareholders agreement alone takes many hours to read and requires a lot of assistance from Tony, who finalizes it with Buffet's counsel. The deal is done!

[Term Sheet]

BUFFET CAPITAL CORP.

Private and Confidential

June 21, 1999

Mr. Stuart Chip
President
New Tech Distributors Corp.
20 Burnaby Street
Burnaby, B.C.
V7V 2R3

Dear Stuart:

This letter will set out the terms of a proposed financing of New Tech Distributors Corp. (New Tech). Buffet Capital Corp., (Buffet) will provide $600,000 of capital on the terms provided herein:

1. On or before July 21, 1999 (the Closing) which date can be extended with mutual agreement of New Tech and Buffet, Buffet and New Tech would enter into a financing agreement whereby Buffet would purchase $600,000 (Canadian) worth of common shares (the Shares) from treasury of New Tech representing 40% common voting interest of New Tech. This 40% interest shall be non-dilutive to New Tech except in the event of a share offering:

    (a) pursuant to a prospectus, registration statement or similar offering having gross proceeds of greater than $4.5 million; or

    (b) where the per share price at which the common shares are offered is equal to or greater than the per share price at which the common shares are issued by New Tech to Buffet.

2. New Tech will use the share proceeds to fund its expansion program including its new computer module production line and marketing campaign.

3. Buffet and the existing shareholders of New Tech shall enter into a shareholder agreement (Shareholders Agreement), which shall provide *inter alia* that:

    (a) Buffet will be entitled to nominate and have elected at least two persons as a director of the company's Board of Directors. The Board will have no more than six directors.

    (b) Buffet will be entitled to receive, within specified periods, unaudited interim financial statements for each of the three-month, six-month and nine-month periods in each financial year and audited annual financial statements in respect of each financial year.

    (c) Buffet will have a 45-day right of first refusal to participate in any additional equity financing of New Tech *pro rata* to its shareholding on identical terms where such financing is other than conventional bank financing. Buffet will give its indication whether it will participate in additional financing within the first 10 days of the 45-day period.

(d) The following matters require Buffet's prior approval, which shall not be unreasonably withheld and be acted upon within 10 business days:

(i) establishment of dividend policy;
(ii) any material increase in the total compensation of any of the "key employees" (provided that any increase which is less than or equal to 15% shall be deemed not to be material) ("key employees" as defined in Schedule A);
(iii) any non-arm's length transactions over $25,000;
(iv) the appointment of any new persons to any of the top four "key positions" within the company; and
(v) any material change in accounting policy.

(e) The following matters require Buffet's prior approval, which shall be acted upon within 10 days:

(i) any material change of business;
(ii) the sale of business; and
(iii) any appointment of a new president.

(f) Where any one or more of the shareholders (the Seller) desires to sell common shares to a purchaser or group of purchasers other than other shareholders (the Buyer) and, as a result, the Buyer would, together with its other holdings, hold at least 45% of the common shares, such sale (the Sale) will be permitted only if the Buyer concurrently makes an irrevocable offer (the Tag-Along Offer) to Buffet to purchase at the same price and upon the same terms and conditions all the common shares held by Buffet.

(g) That a satisfactory employee stock option plan shall be put in place within six months of closing which shall allocate not more than 10% nor less than 5% of the New Tech stock for such plan to key employees.

(h) No shares of New Tech may be assigned or pledged without the prior approval of the Board of Directors.

(i) The Board of Directors shall periodically review acquisition opportunities to encourage growth in revenues and net income.

(j) New Tech shall state its current intention to complete an initial public offering of its common shares by December 2002 (subject to consideration of all relevant factors at the time, including those factors relating to New Tech's business, conditions of the financial markets and the valuation of New Tech and its securities at such time).

(k) The Shareholders Agreement shall terminate on the completion of an issuance of securities pursuant to a prospectus, registration statement or similar offering having gross proceeds of greater than $4.5 million.

4. This offer is subject to the following conditions being satisfied prior to or on Closing except for 4(c):

(a) That there shall have been no material adverse change to the business activities of New Tech.

(b) That New Tech and Buffet's boards of directors shall each have approved the terms of this proposed financing on or before June 30, 1999.

(c) Stuart Chip and other key employees shall each have entered into a satisfactory employment agreement with New Tech to the sole satisfaction of Buffet which agreement shall include non-competition positions.

(d) Formal documentation satisfactory to Buffet and New Tech and their respective counsel shall have been completed.

5. New Tech shall be responsible for payment of all solicitors' fees and other professional fees related to the transaction contemplated herein. In addition, New Tech shall pay Buffet an earnest fee of $25,000 upon acceptance of this proposal. Reimbursement of such professional fees shall only be required to be made, and such payment to Buffet shall only be refundable in the event that Buffet chooses not to proceed to Closing based on the terms as outlined in this letter through no fault of New Tech, (it being understood that in the event that New Tech and Buffet are unable to reach agreement on the terms and entitled to have such earnest fee refunded in full and shall not be liable to reimburse Buffet for payment of its professional fees).

6. Buffet will receive an aggregate director's fee not to exceed $12,000 per annum unless New Tech should otherwise agree.

7. This offer is open for acceptance until the close of business July 21, 1999.

Yours truly,

Walter Buffet
Buffet Capital Corp.

AGREED AND ACCEPTED TO THIS ________ DAY OF________ 1999

NEW TECH DISTRIBUTORS CORP.

____

Schedule A

Stuart Chip

Elizabeth Pratt

Kevin Matley

John Harley

Author's Note:

New Tech has now negotiated a deal. It is near the finish line. New Tech has learned:

- *the importance of responding quickly to offers from investors;*
- *to approach negotiations from a win-win perspective while keeping the investor's position in mind as options are considered;*
- *almost everything is up for negotiation;*
- *negotiations may take time and several meetings; and*
- *to involve legal counsel early as well as after a common language agreement has been drafted.*

Myths

All negotiations are adversarial in nature.

An adversarial stance is simply a negotiation tactic. The investor may want to be seen as a hard bargainer. The outcome of this type of tactic is often a lose-win situation where you give in to accommodate the investor. The most effective way to deal with an adversarial bargainer is to turn the discussion to the problem or objective. This can be accomplished by:

- acknowledging the other party's position;
- using probing questions to gain a clearer understanding of the party's motivations and reasoning;
- giving alternatives and explaining their features and benefits; and
- checking with the party to gain feedback to determine if your alternatives have satisfied any objections. Ensure the issue has been resolved and don't assume that it has been.

Negotiation is similar to the division of a pie, where the pie is a fixed size and the winner is the party who receives the biggest slice.

Negotiations should not be viewed as a win-lose situation. The goal in finding sources of investment financing is to create a situation where both parties will win. Once your business is supplied with capital, your plan is to expand and prosper so both you and the investor share in a greater entity. Keep the discussions focussed on addressing both of your needs and developing a long-term relationship. Both of you can win if you avoid locking yourselves into positions with a winner-take-all attitude.

Only I know the true value of my business.

Although you may think you know the value of your business, the price at which investment will be made will only be determined through negotiations.

It is important to present identical information to all potential investors.

Information in addition to that presented in the investment proposal can be tailored to meet the needs of each investor to increase the level of knowledge throughout the negotiation process.

Frequently Asked Questions (FAQs)

How long will negotiations take?

There is no fixed amount of time to negotiate a financing arrangement. The time will vary with the complexity of the arrangement, the motivation of the participants and many other factors.

- Several negotiation sessions will probably be required before conclusion. Use the breaks to develop alternatives, analyse the other side's reasoning and needs, and assemble additional information to support your objectives.
- Most of the movement during negotiations will likely occur in the 11th hour. For example, everyone knows the best time to get a good price on an event ticket from a scalper is just as the event is beginning. Use this knowledge to your advantage by keeping your concessions near the end of your scheduled meetings. Do not start off by giving in. Keep the discussion moving by switching to different elements or probing to gain more knowledge from the other side. Keep your own deadlines flexible by starting the search for financing early, ideally months before the actual cash is needed.

What is the best setting for negotiating?

To achieve mutual, satisfactory results, it may be best to have both sides focus on the problem or issue at hand. This can be facilitated by having the parties sitting side by side or at a round table with their attention focussed on an illustration of the problem or perhaps a facilitator. Putting people on opposite sides of a table may present a confrontational setting.

Is telephone negotiation acceptable?

Generally, you should avoid negotiating by telephone. Telephone conversations tend to be hurried, forcing you to think quickly and not allowing you time to be thorough. Obviously, this approach does not give you the opportunity to observe the other party's reactions and body language. Persons placing the call are at an advantage because they can be prepared. They will have their documentation in place, the door closed, access to a computer and calculator, and may possibly have an advisor in the room with them. At the same time, the receiver may be in the middle of a task and totally unprepared.

> If you receive a telephone call from the investor intending to complete an important negotiation, you should defer the discussion until later. Say, "I'm sorry, I am late for a meeting with an important customer. May I call you later or meet with you tomorrow?" This will allow you to prepare your own materials. When you call back, you will have the advantage of being prepared while the other party is caught off guard.

Module 8: Close the Deal

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Executive Summary

The previous modules have all prepared you for this final step. If you have been conscientious and methodical in your preparations, you are almost there! Although this is the final step in the process of obtaining financing, this is really the first step in what should become a successful business relationship between you and your investor.

The successful completion of the negotiation process does not signal the end of your journey to obtain financing. There are still a few elements needed to close the deal, the most important of which is the due diligence review. The investor must still perform a due diligence review to ensure that his or her understanding matches the reality of your business.

You can go through this program in two ways. You may want to read the details of the module to get a conceptual view related to closing the deal. Or, you may want to read the case example at the end of the module to learn how to apply some of the concepts and techniques presented in the module. However, the learning process will be enhanced if both approaches are used simultaneously.

Numerous pitfalls could break the deal during closing, and once the deal is closed, you must manage the relationship with the investor.

This module outlines the strategies and skills you will need to close the deal, and manage the due diligence review and the relationship afterward. An example has been provided to illustrate the concepts covered in this module. If you've been following the New Tech Distributors Corp. (New Tech) example, then you are familiar with New Tech's background. In this module, you can follow New Tech as it closes the deal.

This module covers three topics.

1. **Understanding the strategies and skills used for closing the deal.** Before you sign the final deal, there are some very important matters that must be reviewed. Throughout the process, elements of your proposed financing may have changed. Items such as the amount and terms of the investment, or the type of investment instrument, may be different now. You must now re-assess your initial needs to ensure that there is still a match.

2. **Understanding the importance of, and steps involved in, a due diligence review.** The due diligence review allows the investor to verify all the details contained in your investment proposal. Although each review is different, certain areas, such as finances, market potential, management and operations, will probably be examined. The due diligence review provides an opportunity for the investor to see management in action and to get a hands-on feel for the company. At the same time, you should conduct an investigation to ensure that the investor is the right person for you and your business.

3. **Tips on managing the business relationship after the deal.** The relationship with the investor, which has been built up during the financing process, is only just beginning. It will be essential for you to maintain a good working relationship with the investor. Although many factors will contribute to the success of this partnership, the most important aspect of the relationship is honest, open communication between the parties.

Details

1. Understanding the Strategies and Skills Used for Closing the Deal

There are no general rules for the final step of the process. Every investor has a unique approach, but there are certain factors that are common to all closing negotiations.

- The investor will usually have an intermediary to facilitate the negotiations. This individual will be known and trusted by the investor. Consider retaining your own advisor who will work in your best interest. You may be too close to the deal to concentrate on the right issues, whereas your advisor will pay specific attention to all aspects of the negotiations. The investor's facilitator will be familiar with the process and you should ensure that you are represented by an equally competent agent with negotiating experience.
- Trust and chemistry are the key elements of this process. It is important for the investor to be confident that full disclosure has been given. In earlier modules, the need for honesty and openness was discussed. At this stage in the negotiation process, it is critical that you maintain that approach. If you indicate that you have not provided full disclosure, or if you attempt to introduce new information that effectively blindsides the investor, you run the risk of destroying your credibility and the trust you have established. If the investor loses faith in you, the deal will not close.
- You and the investor may be partners for a long time, so make sure the relationship begins properly.

At this point in the process, you should have already negotiated a final draft of the investment agreement that you and the investor intend to execute, subject to due diligence (see Module 7, Negotiate the Deal, for more information).

No doubt some changes to the original proposal have been suggested. These modifications may take several different forms. For example, the investor may wish to adjust the equity position to reflect a different risk understanding, or the investor may believe you have overestimated or underestimated your needs and may recommend adjusting the size of the investment. This is the time for you to step back, collect your thoughts, review your initial proposal and be prepared to reconsider.

You may wish to review Module 1, Identify Your Financial Needs, at this point to ensure that the revised draft agreement continues to meet your requirements. In addition, you should be thinking about the following questions:

- How will any suggested amendments affect your cash flow? Will your cash flow meet your current needs under the restructured proposal?
- Are the proposed changes too restrictive from an equity standpoint? Will you be able to obtain additional equity financing without jeopardizing this agreement?
- Can you still meet your goals?
- Was your due diligence review sufficiently thorough? Were the investor's references responsive and unqualified? Have you checked out the investor's reputation and track record, especially if you did not previously know of the investor?
- Do you generally feel comfortable with the relationship from a chemistry standpoint? Is this the type of investment group you think you can work with?

Amendments to a proposal are not necessarily negative. The decision you are about to make will have a significant effect on your business and personal future. Perfect relationships are never guaranteed. At this point, you can rely on the advice and opinions of your business advisors, key members of your management team and your board of directors.

You should step back and think of the big picture. Are there any reasonable alternatives? If not, what position will your company be in if you do not go ahead with your plans? Can your company afford the management team under present circumstances? Will the company continue to be viable without this investment? Are you prepared to give up a greater share of the business in order to close this deal? Should you just walk away from the table? It is time to make a hard decision based on what you believe is best for you and the company, both now and in the future.

> Walking away from the transaction may be simpler than trying to replace key capital in the event of conflict. Make sure you know and understand the terms and implications of the agreement before you commit yourself.

Legal Implications

It is critical that you continue to involve your legal counsel in the final closing of the deal. You should have obtained legal advice when you were drafting the investment proposal and identifying potential investors. In addition, your lawyer should have been involved in the review of the term sheet that was completed during the negotiation process.

Financing arrangements are governed by provincial statutes that establish regulatory requirements that vary according to the type and amount of the investment. Each province has enacted legislation covering various aspects of business transactions and the issuance of securities by companies. In Ontario, for example, the *Ontario Business Corporations Act*, the *Ontario Securities Act* and the *Personal Property Securities Act* may all contain regulations that may apply to your particular financing arrangement. You should consult with your lawyer to ensure that all applicable regulations, restrictions and registration requirements are considered. In addition, your lawyer should review every document to ensure that the investment agreement conforms to the negotiated terms. Once all the documents are signed, you will find it very difficult, if not impossible, to change, delete or add clauses.

It is a time-consuming exercise reviewing and negotiating the various legal agreements necessary to close the financing. Read the agreements and understand them. Do not rely on your legal counsel to brief you. You will have to be involved in decisions affecting the agreements, such as what representations and warranties the company is prepared to give, the composition of the board of directors, the dividend policy, compensation arrangements, positive and negative covenants, and so forth. One cannot understate the importance of these negotiations on the documents. Many deals have broken down at this stage.

It is important to use a lawyer who is familiar with investment contracts and shareholder agreements. Your existing lawyer may not have the necessary experience to guide you properly and should refer you to a specialist practising in this sector of the law.

Do not rely solely on the investor's lawyer, nor sign standard agreements that the investor purportedly uses "with all the other companies" he or she finances. Regardless of how much you trust the investor and his or her counsel, always remember that they have the investor's interests in mind, not yours. Although many of your interests should coincide (e.g. to have your business succeed), many will conflict (e.g. who has effective control over the business). Without independent legal counsel protecting your interests, you allow the investor to control the agreement.

Outstanding Matters

Often, entrepreneurs overlook certain matters in their rush to close a deal and obtain financing. Probably, when your agreement is signed, your company's capital structure and ownership will have changed. In many cases, it will be dramatically different. For example, investors will have all the rights attached to the class of shares or subordinated debt that they have agreed to purchase.

The inflow of additional equity (or assumption of additional debt) may trigger certain default or restrictive clauses in existing agreements and contracts. For example, you may have signed a document in connection with an operating bank loan that requires you to notify the bank and obtain agreement before you change the ownership structure.

Before the deal is finally closed, ensure that there are no loose strings that could turn into problems down the road. Your lawyer will be able to provide you with guidance on these matters. The following list provides some items that you should consider.

- Do any options or other agreements exist that were negotiated earlier in the company's life that would be unreasonable after the financing? For example, options to purchase shares that may have very low exercise prices in light of the new size of the company.
- Contracts (licences, employment contracts, supplier contracts, etc.) that are expiring in the near future may need to be renegotiated early or allowed to lapse. For example, a supplier may demand increased prices knowing that the product is vital to your expansion or, alternatively, if you will be producing more items in-house, you may need to cancel some contracts.
- Do any existing contracts restrict your ability to enter into new contracts, open up new markets, etc.?
- Are all key employees covered by employment contracts and confidentiality agreements (especially with respect to intellectual property)? Key employees extend past management and may include scientists, engineers, plant managers, etc.
- Did you enter into any related party transactions that, while appropriate when you were the sole owner, may no longer be appropriate? For example, payments to management companies, special dividends or shareholders loans may need to be attended to.
- You may wish to settle any potential or contingent liabilities (i.e. lawsuits) as an award granted after the financing may be larger simply because your company is now larger.
- Are you satisfied with your current auditors and legal counsel? Changing advisors may be more difficult later on with additional owners who must consent.
- Are there any agreements, contracts, etc. that will terminate or materially change as a result of a new share issue, share dilution, the assumption of subordinated debt or a change of control?

- Ensure that all banking arrangements contemplate the new financing structure and that there are no outstanding issues relative to security documentation, required notice or forced repayments.[1]

Although the above list does not include all the matters that must be dealt with prior to closing the deal, it provides a sample of the types of issues that may affect your personal affairs and those of your company. A few hours of investigation now could eliminate serious repercussions at some point in the future.

2. Understanding the Importance of, and Steps Involved in, a Due Diligence Review

Up to this point in the financing process, the investor has relied mostly on information you have provided, such as the financial status of your business, industry market and comparative data.

The due diligence review allows the investor to verify all the information provided to date and to obtain additional data, if necessary, for the decision-making process. Although an agreement in principle is likely to have been negotiated at this stage, it is almost always conditional on the completion of a due diligence review. If the due diligence review indicates that the information you have disclosed is misleading or inaccurate, the investor could back out, leaving you without any financing. This is a relatively common occurrence, so it is vital that you facilitate this step in the process. You want the investor to know exactly what he or she is getting for the money.

Every investor will perform the due diligence review in a different manner. Some will have advisors (usually large accounting firms) perform the task, whereas others, often angels, will handle it themselves. However it is structured, the due diligence review generally focusses on your financial status, operations, quality of assets, competence and depth of management, and market potential (current and future). You must be flexible in helping investors meet their objectives and deadlines. You should ensure that all your key managers make themselves available during the process.

There are important points to remember when preparing for a due diligence review.

- The investor is likely to want additional quantitative and qualitative information that is not contained in the investment proposal.
- If requested by the investor, allow your management team to participate in the interview process with the investor, either individually or as a group.
- You should ensure that your banker, lawyer and accountant are adequately prepared to receive a visit or telephone call from the investor. You might be asked to have them attend a group meeting with the investor at your facility, but be prepared and expect the investor to want to speak to each of them alone.
- Make sure the investor understands your product and where it sits in the product life cycle.
- If your business is in a leading-edge or high technology industry, the investor may employ the services of an expert in the field to assist with due diligence. This individual will want to meet with management members who can participate in a technical dialogue.

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[1] Adapted from Jay Lefton, "Public and Private Financings: A Legal Perspective," Aird and Berlis, Barristers and Solicitors, Toronto: November 21, 1994.

- The investor may wish to speak to major clients or suppliers, and you should be prepared for this occurrence. You should contact clients and suppliers in advance to give them permission to speak with the investor.
- Be prepared for challenges and for a lack of understanding. Be positive in your approach to this process, not defensive.

> Try to develop a set agenda with the investor up front. This will avoid any surprises and allow you to be better prepared. Also, obtain a listing of all the information that will be required during due diligence and have it prepared before the investor arrives.

Typical Documentation/Information Required by Investors

As discussed previously, different investors conduct the due diligence review process differently. You should be prepared to provide all pertinent materials. The following list (which is not exhaustive) provides examples of the types of documentation and information generally requested:

- published financial statements for the last four or five years;
- company-prepared interim financial reports and analyses;
- recent business income tax returns and payment schedules (You may wish to review the modules Identify Your Financial Needs and Demonstrate Your Investment Potential to verify that your cash flow forecast takes taxes into account.);
- auditors' working papers and all pertinent correspondence with the auditors;
- summary (and copies) of the main contracts in place (You should include shareholders agreements, employment contracts, leases, patents, insurance policies, mortgage documents, and sales or supply contracts.);
- a list of key customers with historical and projected sales data and order backlog, if available;
- a list of primary and backup suppliers (especially if you purchase a speciality product or service);
- if your company is a manufacturer, returns and warranty data may be needed to assess the quality of the product and to assess any contingent liability related to your products;
- recent appraisals of tangible assets;
- press releases, speeches by management and marketing materials released in the past few years;
- an organization chart and copies of any employment, consulting and confidentiality agreements with key employees;
- corporate minute books and documents (i.e. articles of incorporation, by-laws);
- a summary of all outstanding or pending litigation with an accompanying opinion letter from your lawyer explaining the expected outcome of each lawsuit;
- market due diligence (The investor will want to review the support for the market data that you provided in the proposal and will also want to get a better feel for the company's market potential.);
- a strategic plan that focusses on the big picture for the next 5 to 10 years and incorporates your vision of the company; and
- historical and future forecasts, along with actual figures, to assess management's ability to produce accurate forecasts and to determine future expectations.

> Make sure all the information you are compiling supports the applicable sections of your investment proposal and any verbal representations you may have made; otherwise, the investor may question your credibility.

Financial Review

A due diligence review will always include a detailed look at the financial status of the company. The investor will want to verify the information he or she has received against the financial records of the company. When the investor is confident in the accuracy of your financial records, the credibility of your forecast data is enhanced.

A strong balance sheet also makes an investment more attractive. A certain amount of debt is expected; however, if the company's debt load is excessive, the investor will be concerned about your real intent for the funds generated from the investment. Do you really intend to expand, or will you simply retire existing debt?

The investor typically wants to ensure that your capital structure will sustain the business through its growth period. A company with an unbalanced financial structure (too much debt or equity) is likely to encounter difficulties ranging from a lack of liquidity to poor rates of return. In most cases, these types of problems are eventually terminal.

The financial review is one of the main sources of information regarding management's financial capability (see Module 3, Demonstrate Your Management Capabilities). When preparing your forecasts, you should have already reviewed your financial information with an advisor (see Module 4, Build an Investment Proposal). If you have not done so by now, it may be useful to have your accountant or financial advisor review your financial data before you proceed with the due diligence review. It is essential that you are aware of all weak areas in your financial material so you will be properly prepared to explain them to the investor.

Market Review

This will generally consist of a review of the underlying market research data that were developed in Module 2, Demonstrate Your Investment Potential, and summarized in your investment proposal. The information required will vary depending on the type of market. However, be prepared to disclose your market research data, questionnaires, responses and analyses. If you operate in an existing market, you will need to provide market demographic studies. If you expect to create a new market, you will need to produce a detailed analysis of the potential for the market, future demographics and how you will develop your share in that market. Reports prepared by outside consultants, particularly if they are recognized experts in their field, will add significant credibility to your estimates of the market size and how your product will serve the target market.

All aspects of your marketing plan that were included in your investment proposal will be thoroughly examined at this stage. You will need to provide support for the assessment of your position in the marketplace with respect to your present and future competitors. Be realistic. Investors tend to be wary of anyone who indicates that he or she has no competition or who completely discounts the competitors' ability to challenge him or her in the marketplace.

Review of Management

The investor is doing more than just buying into a business. The investor is buying into you and your management team. Therefore, the evaluation of your management capabilities will be an integral part of the due diligence review. The investor wants to make sure your team can implement the business plan and will want to get to know your management team better. This means key members of your management team must be fully conversant with, and support, the business plan. Management must be prepared to respond to some difficult questions. You should review the module Demonstrate Your Management Capabilities to assess any weaknesses with current management and have a plan to address them.

The following list provides an example of the issues that may need to be addressed in this very important part of the due diligence review.

- If all key management biographies and résumés were not included in the investment proposal, a complete information package containing this material should be made available to the investor at the beginning of the due diligence review.
- The investor will review the background and employment history of key employees very carefully, so if there are any unexplained gaps or blemishes, you should be prepared to explain them.
- The investor may require business and personal references for each key member of management.
- Does your company have a formal extended education support system?
- Do you utilize the services of external consultants to ensure that your product or marketing strategies are leading edge? For example, are you affiliated with a university or college program? Do you bring in external expertise to keep your management team up to date?
- Is the chemistry within the management team positive? The investor will want to see a good cross section of skill sets, complementary personalities and a cohesive approach to problem solving. In addition, the investor will look for a team with demonstrated strengths that compensate for any identified weaknesses.
- Is there a natural leader and will this be apparent beyond the share structure? The investor may want to meet with the management team in your absence, so be prepared for this eventuality.

Always be open and honest with an investor about management shortcomings or past failures. Most investors look for people who have learned from their mistakes (and can avoid them in the future) rather than people who claim to be perfect. Also, sophisticated investors have an extensive network of contacts or may have skills to fill gaps in management, but only if they are aware that those gaps exist.

Review of Operations

The investor may have already visited your premises and will likely return as part of the due diligence review. Many investors develop a gut feel for the type of people they are investing in by walking the plant floor. You should ensure that all your staff, including people in the factory and office, are aware that an investor will be touring the facility, so they can put their best foot forward.

The investor may have unique industry knowledge in the operations area and may critique the manufacturing layout. This could be a positive development.

Some investors prefer to make surprise visits during the financing process to ensure that the employees are not just "acting" while visitors are present. Although you should encourage your employees to welcome the visitors, exaggerated behaviour is easily spotted and may suggest that the day-to-day reality is being hidden. Ensure that your business is ready for such a visit any time during the process.

Here are some thoughts to keep in mind when the investor is conducting a plant tour.

- Make sure your premises are neat and tidy but also look like an ongoing operation.
- Ensure that you have appropriate safety equipment available for the visitors, if necessary, and that it is properly used.
- The investor will be looking at the people to get a flavour of the culture and communication process within the company. Encourage your employees to act naturally and normally.
- The investor may stop and talk to some of the employees as they walk through the plant and office, so be prepared. You should ensure that all appropriate safety precautions are taken by employees during conversations with the investor, such as shutting down equipment that requires constant monitoring.
- It is a good idea to allow the members of your management team who are specifically involved in each process to provide an overview during the visit. For example, you may wish your production manager to accompany the visitors on a tour of your production line.
- The investor may want to look at the order book right on the spot, so make sure your team is prepared to meet this potential opportunity.

> It is not necessary to organize a fancy visit with a limousine ride and lunch at an expensive restaurant. In fact, many investors see this as a sign of poor financial management because the company is wasting money that should be spent on its operations. Remember, if the company had lots of money to spend you wouldn't be looking for financing!

Technical/Technology Review

If the business depends on specialized technology, the investor will typically want to exercise extensive due diligence in this area. If investors don't have a technical expert on staff, they can generally hire a consultant with such expertise. An example of a review for a software company is an expert reviewing the software source code.

Your Own Due Diligence (with the Investor's Permission)

Your involvement with the investor is a relationship, and as such, both parties have to be comfortable with each other. Even though your due diligence review will be much simpler than that of the investor, it is just as important to the success of the partnership.

If you have succeeded in establishing interest with more than one investor, evaluate them and choose the most appropriate partner. Even if only one investor has expressed an interest in considering your investment proposal, you must determine the compatibility with your company. Do not panic. The risks associated with your involvement with an incompatible investor, or with an investor who has a hidden agenda, will quickly outweigh any benefit you may receive from an immediate commitment. Many entrepreneurs look only at the amount of money an investor is offering. It is as important to consider other factors such as the contacts, experience and expertise they can offer. If your business does encounter difficulty, an experienced, committed investor-partner could make the difference between success and failure.

The following list is an example of the types of issues you should address when conducting your due diligence review of the investor.

Honesty and integrity. Can you trust this person to keep his or her word and honour verbal commitments? Will you need signed contracts for every matter?

Past track record. Is this person usually involved with successes or failures?

Typical investment philosophy. Will this person be an active or a passive investor?

Size. Does the investor have sufficient capital to provide you with a second round of financing if you require it in the future?

Stability. Has the investor been in business for a long time and what is included in the investment portfolio? Is the investor financially strong? If the investor goes bankrupt, your financing may belong to one of the creditors, who may not share the investor's enthusiasm for your business.

Expertise and experience. Does the investor have industry expertise related to your business? Will he or she be a useful addition to your board of directors? Does he or she have management skills that compensate for weaknesses in your current management team?

Network. Does the investor have a large network of contacts into which you can tap to find management expertise, potential customers or suppliers?

Problem investments. What does the investor normally do with investments that underperform? Does he or she exit from the financing arrangement, take over the company or arrange to work it out with the entrepreneur?

Personality. Is this someone you feel comfortable working with?

At a minimum, you must obtain knowledge about the investor in these areas. Most reputable investors will allow you to contact other businesses they have financed as references. Other good sources of information include bankers, business associates, financial newspapers, magazines and your own business advisors.

Don't be afraid to give up some control to a knowledgeable and trustworthy investor. It may mean the difference between success and failure. Remember that 40% of a successful business is worth more than 60% of a failed one!

3. Tips on Managing the Business Relationship after the Deal

Once the deal has been closed, the relationship with the investor is not over. In fact, it is just beginning. Never forget that this is a partnership that must be carefully maintained to avoid larger problems down the road. The key to a successful relationship is honest and open communication. The investor must be made aware of all significant developments, even if they are unfavourable. Remember that it is always better for you to break the bad news than for the investor to learn about it from other outside sources. If you raise the issue first, you will have an opportunity to discuss your plans to address the situation or to seek the investor's advice.

Most investment agreements will require formal reporting on a regular basis, such as the completion of a monthly financial reporting package. You should treat this as the minimum level of communication between you and the investor. In order to maintain the relationship you should:

- communicate — ensure that the information requested by the investor (i.e. monthly financial statements) is provided on time, according to the schedule contained in the agreement;
- provide a meaningful management overview that explains the numbers when providing monthly or quarterly financial reports to the investor;
- make sure the investor is aware of market trends and developments (You might consider inviting the investor to strategic sessions or industry seminars presented by external experts.);
- ensure that the investor feels comfortable in joining board of directors meetings (Remember that the investor may be entitled to representation on the board as a condition of the investment.); and
- make sure the investor is aware of all major decisions. This policy not only keeps him or her up to date on developments, but also tends to remove potential conflict down the line. However, remember that the investor is your partner and not your boss. Follow your normal operating procedures and involve the investor in those decisions that are required by your investment agreement or shareholders agreement. Accept the investor's input as a positive contribution, but do not follow it blindly.

The above ideas should help you to maintain a good working relationship with the investor. Regardless of what you have to do to maintain the relationship, ensure that you have a common trust. If the investor feels you are not forthcoming and loses confidence in you, the remainder of your relationship will be very difficult. Conversely, if you have similar concerns about the investor, you should re-evaluate the advisability of continuing the relationship. It is not unheard of to have entrepreneurs spending more time managing conflict with the investor than their business.

Credibility, honesty, trust and confidence are the most important elements in a successful partnership. You must ensure that these elements exist throughout your relationship with the investor. Cultivate and nurture them, and your relationship with the investor will grow. Ignore them, and your relationship will dissolve.

4. Conclusion

You have now completed the last step to building investor relationships. In this module, you looked at:

- various strategies and skills used in closing the deal;
- the importance and steps involved in the due diligence review; and
- some tips on managing the business relationship after the deal.

Having completed the first 8 modules, it is now essential for you to maintain a good working relationship with your new investor. Many factors will contribute to the success of your partnership, the most important of which are open and honest communications.

These modules have all been designed to assist you in obtaining risk capital financing. Although these modules provide one way of proceeding through the investment process, it is really up to you and your management team to chart your own path to success.

"Success is a journey, not a destination." (Anonymous)

Case Example

This case example allows you to follow a fictitious company, New Tech Distributors Corp. (New Tech), as it seeks risk capital to finance its growth. The case shows how New Tech addresses the key elements presented in the Details *section of each module.*

If you have not already done so, read about New Tech's background and the challenges it faces in the earlier modules. As well, you may wish to refer to the Steps to Growth Capital Overview for an introduction to the overall structure of this program.

New Tech is near the finish line, based on its negotiations with one investor. With a negotiated agreement as discussed in Module 7, New Tech must prepare for the comprehensive due diligence review. Read about the information New Tech gathers in preparation for the due diligence review and the closing of the deal. You should refer to the Identify Your Financial Needs module and the Details *section of this module for more information related to this subject.*

The Closing

One of Buffet's conditions, before closing the deal, is being satisfied with the results of comprehensive due diligence. He has already done high-level due diligence, which includes checking the personal and professional references of the management team.

New Tech also contacts some of Buffet's investee companies and confirms that Buffet is viewed as an outstanding angel investor. New Tech consulted Tony Lee of Smith & Smith, the legal counsel, at the beginning of the financing search. He recommends various housekeeping matters that would make the due diligence review more smooth. For instance, New Tech's patents on several modules had not yet been filed. A contract with one of the Japanese semiconductor suppliers is expiring, so Tony suggests New Tech arrange to renew it. There are a number of non-arm's length family loans to be eliminated. Tony also suggests New Tech engage a firm of auditors, as any investor is likely to insist on it. He advises that the transaction New Tech is about to enter into with Buffet is in compliance with securities regulations.

Grant Agent (New Tech's financial advisor) meets with Stuart Chip (New Tech's CEO) and Elizabeth and advises them to be prepared for the due diligence review. Buffet will be using Numbers & Co., a major accounting firm, to assist with the process. Grant suggests that Elizabeth speak with Numbers and have it send her its due diligence program. By program, Grant means how many days Numbers is planning to be on site at New Tech, the focus in the morning and the afternoon of each day, and specific information New Tech could pull together in advance to make the process productive. He says Numbers is going to give feedback to Buffet not just on the numerical results of the work, but qualitative factors such as perceptions of management. If the due diligence review is chaotic due to New Tech being disorganized, it could backfire and Buffet could change his mind. He also warns Elizabeth that she should ensure that the management team is going to be in town during the due diligence review. Numbers would likely be requiring input from each manager.

Elizabeth contacts Numbers and not only does the company forward its work plan, but meets with her in advance to confirm details.

Numbers provides the preliminary request for information:

- New Tech's financial statements for the last three years;
- three years of income tax returns and payment schedules;
- details of banking arrangements;
- summary (and copies) of the main contracts in place (contracts, leases, patents, insurance policies, mortgage documents, sales or supply contracts, etc.);
- list of key customers with historical and projected sales data and order backlog, if available;
- additional industry information on the computer power module market and related technology;
- list of suppliers and backup suppliers (if part of the needs is a speciality product or service);
- returns and warranty data to assess the quality of the product and to assess any contingent liabilities related to the products;
- recent appraisals of tangible assets;
- an organization chart;
- corporate minute books and documents (i.e. articles of incorporation, by-laws, etc.);
- a summary of all outstanding or pending litigation with an accompanying letter from the company's lawyer explaining the expected outcome of each lawsuit; and
- historical and future budgets along with actual figures, which will be required to assess management's ability to produce accurate forecasts and to determine future expectations.

Buffet sends Egor Krincz, a renowned computer module specialist, to examine the technical specifications of the modules and to interview the engineers. Buffet also conducts an extensive review of the market opportunity for the computer modules by examining industry data he and New Tech gathered, speaking with others in the industry and doing further research on the competitors. He also relates these data to New Tech's forecasts to determine if the sales projections for the modules appear reasonable. At one point, the due diligence review almost comes to a halt after Krincz thinks he has discovered a flaw in the modules' operating system. After intensive discussions with the engineers, he is satisfied there is no flaw.

Other than the delay caused by Krincz, the due diligence review takes four days on site and is completed at the office of Numbers. Buffet calls Stuart to congratulate him and his management team on the professional way they handled the process. The closing takes place the following week at the offices of Buffet's solicitors with Tony, Stuart and Elizabeth in attendance. Stuart says he has never signed so many documents, but he is pleased to endorse the $600,000 cheque.

The Partnership

Months after the deal closes, the management team meets to reflect on the relationship with Buffet. The team believes one of the most important factors that makes the relationship work is open communication. Buffet is copied not only on monthly financial reports, but on key memoranda. He is a key player when the management team meets to formulate the strategic plan. His experience in growing small companies is invaluable; he often points out alternative strategies that expand Stuart's horizons. At the same time, New Tech does not always accept everything Buffet suggests, and he is pleased to be challenged.

Author's Final Note:

New Tech has successfully closed the deal! The good news is it has reached one finish line. The better news is it has embarked on a whole new journey in partnership with an investor who can help it to achieve its growth opportunity. New Tech has learned:

- *investors conduct their own comprehensive due diligence review as the deal approaches a close;*
- *to be prepared more than ever for the due diligence review;*
- *it can also check investors' personal and professional references;*
- *the importance of legal counsel and other close advisors while closing the deal;*
- *investors can often contribute to the success of the business through contacts, strong skills, knowledge and experience; and*
- *investors will take an interest in how their investment is being managed.*

The preceding case was designed to illustrate some of the key learning points contained in the eight modules. While New Tech chose one path in obtaining risk capital financing, this is by no means the right and only path. Based on your experience, the needs of your business and the advice of others, you will undoubtedly pick a somewhat different route in your search for risk capital financing.

Myths

Due diligence is a mere formality.

Even though some agreements are signed before due diligence, they will always be conditional on an acceptable due diligence review. More than one entrepreneur has lost key financing because he or she did not properly prepare for this process. You can use due diligence to your advantage; it is your last chance to sell yourself and your company to investors. Even if they have already decided to invest, it does not hurt to make them feel even more comfortable that they have backed a winner.

The only thing an investor wants to see is a good business plan.

It is true that a good investment proposal will get you in the door; however, the investor is equally concerned about management. Management implements the business plan and is therefore critical to the ultimate success or failure of the company. Investors know that a great strategy with poor implementation will not produce good financial results.

You don't have to worry about the investor's needs after you get the money.

This is a common problem with some entrepreneurs who never develop a good relationship with their investors. If you do not continuously meet the investor's needs, he or she may pull out the money under exit clauses in the investment agreement or may be less willing to help you work out problems when they occur. A successful initial investment may lead to further investments as your business grows. Finally, most investors and angels know each other reasonably well. If you lose your credibility with one, you may find it difficult to access this type of financing in the future.

Frequently Asked Questions (FAQs)

If I have audited financial statements for my business, will I still need a due diligence review?

Yes, almost every investor will undertake due diligence on every company he or she intends to invest in. The auditor has only provided an opinion on your formal financial statements. This does not cover much of the information that you have provided to the investor, including forecasted cash flows, market statistics and technical information. Audited financial statements are historical. Although this is important, they do not have the same level of significance as future-oriented information (such as forecasts). Having said that, investors will still feel more comfortable knowing that your past financial statements have been audited, and it will reduce the amount of due diligence time spent on verifying past financial information.

The investor has said that I must pay for his legal costs and the costs of due diligence. Is this true?

There are no laws or regulations preventing the investor from asking you to pay for these costs. Although every investor operates differently, the bottom line is that you need his or her money so you may need to pay for such costs. You can always refuse, but this may mean the end of your financing negotiations. If you do agree to pay these costs, ensure that you reach an agreement on a time budget and a maximum amount before the work begins. This will protect you from runaway legal and consulting fees.

My lawyer has already reviewed the draft shareholders agreement and only minor changes were made. Does he or she still need to review the final document?

You should always have your lawyer review the final version of the agreement you intend to sign. Changes you regard as minor could have major repercussions in terms of the documentation to be filed or the impact on your business. Also, if your lawyer has already reviewed the draft, it shouldn't take him or her much longer (and cost you much more) to look over the changes.